Corporate Governance for a changing world

Capturing long-term value: Integrating environmental, social and governance factors into investment and management decisions

Executive Summary[1]
London, September 2015

Event co-hosted by Frank Bold and Tomorrow's Company at Cass Business School.

Introduction

Environmental and social sustainability issues are material financial matters posing both opportunities and risks to the long-term success of companies and the economy as a whole. In recent years, consensus has begun to emerge that firms should focus on creating long-term sustainable value. Leaders in the business, investor and other communities now realise that we must integrate sustainability into the core of our economic system. Amidst complexity and increasing societal expectations on corporations, it remains unclear what corporate governance should deliver in terms of addressing environmental and social issues.

At this event we were joined by Dr. Roger Barker of the Institute of Directors (UK) for a deep-dive session on corporate governance designed for company secretaries, senior management and board directors. The facilitated roundtable discussion gave participants the latest information on best governance practices and regulatory developments, and discussed how to ensure effective governance delivery to internal and external stakeholders.

How can corporate governance address the conflict between market demand for strong short-term performance and the longer perspective necessary for sustainability?

- Keynote speech by Roger Barker of the UK Institute of Directors -

Roger Barker opened the discussion by arguing that the UK corporate governance model fails to foster a long term business approach because listed companies place a much greater value on immediate returns at the expense of investing in long-term economic viability. This dampens innovation and limits research and development, hiring, and the ability of companies to be environmentally sustainable, all of which negatively affects UK's competitiveness.

What can we do to counter these short term tendencies? First we must acknowledge the problem, which is disputed particularly by fund managers in the City of London. Many believe the UK has an excellent governance system that protects minority shareholders, subjects managers to market discipline and allows activists and take-over threats to discipline wayward managers.

> "Short termism is one of the fundamental fault lines of our economic model."
> Roger Barker

The Kay and Cox Reviews concluded that these beliefs were misfounded. Academic research at the Bank of England, especially by Mervyn King (1973) revealed the market discount rate for the valuation of investment streams and opportunities.

John Asker, Professor of Economics at UCLA (2014) reviewed financial studies comparing the behaviour of stock market listed and privately held companies across a large data-set of US enterprises, comparing similar

[1] The academic basis for this project is provided by Dr. Jeroen Veldman and Prof. Hugh Willmott, who run the Modern Corporation Project at Cass Business School, London (themoderncorporation.org)

firms in terms of size, sector and other variations. The research concluded that privately held companies systematically invested in the long-term more than listed companies, and listed companies that were least responsible to potential investment opportunities were in sectors with the highest share price volatility.

It is no surprise that public shareholders are more short-term since liquidity is more easily achieved for public shares than private ones, so a longer-term view is normally taken by those held privately. The average holding period for British and American equities has declined from over six years in 1950 to less than six months today. More than half the daily turnover is undertaken by short-term trading by high frequency traders and hedge funds. Mr. Barker questioned the conventional wisdom that six months is an average with pension funds and insurers holding long-term liabilities taking a longer perspective. Institutional investors held approximately half of equities in the 1960s but now represent only about 15% of UK equities. Furthermore, since the 1990s the process is now outsourced to fund managers that are mandated to a beta-benchmark over a specified time scale. Spence Johnson (2014) found that UK pension funds give their fund managers approximately 12 months to recover from poor performance, down from 20 months in 2008.

Taken as a whole, this suggests that investors are increasingly short-term oriented. The pressure is transmitted to company behaviour through executive pay over relatively short time horizons (typically three years), which encourages share buybacks at the expense of long-term investments (Smithers 2012).

Mr. Barker argued that a deeper issue is that professional advancement is tied to advocating faster rates of change and return. For example, Barclays CEO Anthony Jenkins seems to have been ousted due to an internal impatience that led to the board of directors losing faith with him after only a few years, without any clear external demands for his replacement. This impatience has contributed to a median CEO tenure that has decreased to less than five years.

It is naturally more challenging to identify the solution than the problem. Mr. Barker suggested that shareholder primacy continues to be a workable model of corporate governance, as was concluded by the company board steering group before the adoption of Companies Act, 2006. He disagreed with recent arguments by the Bank of England (Haldane 2015) and Financial Times economist Martin Wolf (2014) that England should move to integrate stakeholder voice into governance, such as by giving employees a seat on the board. Mr. Barker posited that shareholder value creation need not be equated with maximising short-term profits or share price (described by former GE CEO Jack Welch as the 'dumbest idea in the world'). Investor short-termism, in Barker's opinion, arises from the lack of a major controlling shareholder in the modern UK shareholding structure, which could shield companies from share price fluctuations, hostile takeovers and possibly foster a longer term outlook.

While many argue that European companies perform well with a pluralist stakeholder approach, Mr. Barker suggested that it was rather their more concentrated ownership structure, often based on strong family ownership in listed companies, which enabled them to take a longer-term perspective than their UK counterparts.

Multiple voting structures: a plausible option to foster long-term investing?

Perhaps the best option for the UK context would be to find a way to give longer term shareholders more control over listed companies or incentivise investors to take a longer term approach. One mechanism to achieve this is the more widespread adoption of multiple voting/loyalty shares, which are prevalent in countries such as Sweden, France and Denmark. In France, the loi Florange (2014) set the default so that shareholders will double their voting rights after two years. Companies may opt out of this default through a shareholder vote. In the US, it is common for companies to list with dual class (A and B) share structures whereby the B shares may lose their voting privileges if traded to another party. The objective is to concentrate power in the hands of shareholders that are interested in long-term control. Dual class

share structures are particularly common within Silicon Valley technology firms where they represent 7% of all companies, including Google, Facebook and Amazon, as well as media conglomerates such as the New York Times (Fenwick and West 2014).

Institutional investors often oppose differentiated voting rights as they perceive them as a means for larger blockholders to strengthen their control at the expense of minority holders. Earlier this year, UK investors successfully campaigned against a new law in Italy that would have doubled voting rights for long-term shareholders, arguing that it would deter foreign investment.

> "What we need to realise is that all companies are different and therefore need a differentiated approach to governance. Corporate governance is not one-size-fits-all. I fear that the current system in the UK is too focused on protecting minority shareholders and exerting short-term financial discipline."
> Roger Barker

Mr. Barker suggested that multiple voting structures should be permitted on the London Stock Exchange to allow UK-listed companies to compete with their rivals in the US and Asian technology industries, provided the process is transparent and appropriate to the company. Multiple voting structures would prioritise patient and informed shareholders that understand the company's strategy and are prepared to take the longer term view in the face of significant uncertainty under potentially difficult financial circumstances.

Recent global regulatory changes and developments

- Presented by Paige Morrow, Head of Brussels Operations at Frank Bold -

The G20/OECD Principles of Corporate Governance were released on September 5, 2015 with revisions that focus on protecting minority shareholders, increasing financial disclosure and promoting say-on-pay. While non-binding and non-prescriptive, the Principles are highly influential on global corporate governance trends. The OECD has launched a Trust and Business Project to promote a discussion about the effective integration of business integrity considerations into a company's decision making. This underpins the responsibilities of the board and executive management (as defined in the Principles) and aims to help companies better mitigate the risk of serious corporate misconduct.

At the EU level there have been several relevant developments affecting corporate governance and company law, including the revision of the Shareholder Rights Directive. The revision passed a plenary vote in European Parliament in July 2015 and is proceeding into trilogue negotiations between the Council, Commission and Parliament in autumn 2015. The Parliament eventually rejected proposals from the Legal Affairs Committee that would have introduced incentives for long-term shareholding and allowed workers to given an advisory opinion on senior executive compensation schemes. Highlights of the revision include:

- a recognition in EU law that shareholders do not own publicly traded companies,
- the introduction of tax transparency requirements that would introduce country-by-country reporting (that exceed the minimum requirements suggested by the OECD), and
- a non-binding say-on-pay and the requirement that institutional investors and asset managers adopt an engagement policy that monitors environmental and social risk.

An important development coming up on the horizon is the Directive on disclosure of non-financial and diversity information, which will require more than 6,000 large EU businesses to report on environmental matters, social and employee-related aspects, respect for human rights, anti-corruption and bribery issues, and diversity on boards of directors as of 2017. The underlying aim is to improve corporate governance by

increasing transparency and pushing companies to prioritise the disclosure of extra-financial information.

As part of its package on corporate governance and company law, the EU is also contemplating the adoption of a common framework for single-member limited liability companies (commonly referred to as 'Societas Unitas Personae' or 'SUP'). The objective is to facilitate cross-border business activity for micro-enterprises and SMEs. Key characteristics of SUPs would be the availability of online registration, only 1 euro/pound minimum capital reserve, lack of stipulation for employee representation, and labour law being covered by existing national laws.

Concerns have been raised by observers about the lack of size restrictions on SUPs, which would their facilitate their use by large companies, to evade tax rules or for money laundering; the lack of protection for both creditors and employees; and the possibility of splitting the company's registered seat and the place of central administration (which has implications for issues relating to employment, tax and eventual bankruptcy proceedings).

Future Scenarios

- Moderated by Filip Gregor, Head of the Responsible Companies Section at Frank Bold -

Breaking into small groups, participants debated what corporate governance innovation could be adopted by listed companies to address short-termism. Each group assumed a different role (CEO, board of trustees, institutional investor) and then design a corporate governance innovation to foster long-termism. Looking 25 years into the future, each group was asked to visualised the successful implementation of their idea and work backwards to identify the major milestones along the way to success, the barriers that were overcome, and the allies that supported implementation (see e.g. Quist and Vergragt, 2006 for a more detailed explanation of backcasting)

Quadruple Bottom Line - Purpose

The first group, representing the board of directors, added a fourth 'P' to the concept of the triple bottom line (people, planet and profit) to include 'purpose' or 'principle'. The company intended to articulate its long-term purpose, either an objective that was immediately achievable or could be achieved within 10 years. It was agreed that support was needed from both internal leadership - in particular from the board - and shareholders. Motivation is crucial to integrating sustainability into the business.

The group examined two interesting case studies: reference was made to the introduction of hotel reuse towel programmes. The use of cards asking hotel guests to reuse their linens, which has become standard practice in millions of hotel bedrooms worldwide, began with the vision of a board member at International Hotels Group. The group also discussed the challenge of articulating an ethical purpose for the global jewellery industry in order to 'do the right thing' for primary producers and ensure that conflict diamonds do not enter the market.

Articulation of successful, sustainable business vision

Another group represented the management team and started their discussion with the interconnected questions of what the world is going to be like in 10 years' time, and what is needed to succeed in that world? They agreed that many of the challenges businesses are already grappling with - including resource constraints, the potential impact of climate change and population increases and water shortages - will

become increasingly predominant. The group decided to articulate a vision for how a successful business needs to operate now and into the next 10 years to continue to be successful and make a positive contribution to addressing the identified global challenges.

The first aspect in implementing this vision was to articulate a business strategy that took sustainability seriously and internalised impacts that are presently considered externalities, e.g. noise pollution, carbon emissions and over harvesting of fish.

The second strategy was to use education within the business at every stage of employment: recruitment, training and ongoing education, and also to challenge business school to teach differently by funding courses, curricular development and professorships designed to instill a different way of thinking and operating in business.

The third step was to redesign the company's incentive structure for every level of employee to ensure that middle managers and frontline employees were aligned with the same incentives as those of senior leadership.

The fourth element was to communicate to investors that the company would be focused on the long-term (similar to what Paul Polman did when he became CEO). The company would then report on how it was delivering on its purpose by integrating his into its reporting framework, such as that developed by the International Integrated Reporting Council (IIRC), which requires reporting on the six capitals (environment, manufactured, intellectual, social, financial and human).

The group suggested that the CFO should take ownership of reporting on sustainability and a board member would be responsible for oversight to ensure that it became part of the organisation's decision-making structure, rather than be consigned to an isolated CSR/sustainability department. It was considered important for the process to be done transparently with a public commitment to change in order to allow customers, investors and employees to judge implementation against clear benchmarks.

Complete integration of ESG into business strategy

A group representing institutional investors decided to integrate ESG factors into mainstream fund management and eliminate the consideration of these elements by a separate ESG analyst or department. It was considered that this would be a way to embed this way of thinking into the way that all fund managers make investment decisions and reinforce the point that ESG factors drive investment performance for all classes of assets.

It was recognised that the accumulated evidence of the link between ESG and financial performance needed to be better communicated to fund managers. A significant challenge is the preference for quantifiable indicators, which creates a challenge for measuring qualitative aspects of performance, such as the ability of a business to innovate and develop valuable new products.

At the same time, end beneficiaries should be expressing their desire to see ESG issues integrated into investment decisions to the trustees or fund managers. Additional factors include financial regulation and voluntary codes, such as the UN-supported Principles for Responsible Investment (UNPRI). The general trend is to push funds towards greater transparency of how they incorporate ESG issues into investment decisions and report on the ESG-performance of companies. On a somewhat dispiriting note, the group acknowledged that an external disaster would likely help to shake companies and fund managers into taking sustainability issues seriously and respond to the risk of climate change.

Reporting on corporate purpose

The last group was composed of regulators, who were split on the action that should be taken to push boards to consider the long-term consequences of their actions. They agreed that companies should be required to report on the purpose of the company and this could include an explanation of how the company is delivering on the public good or around a business model such as 'B Corps'. Some participants favoured the use of incentives such as tax benefits, while others were skeptical about the unintended consequences of manipulating tax rates without first studying the expected impact. There seemed to be consensus that companies should be encouraged to behave more like citizens in terms of their impact on the world. The question left to answer was whether companies should be rewarded for good behaviour, and if so, how.

Identifying the main corporate governance challenges and opportunities over the next decade

- Moderated by Stefan Stern, management writer and visiting professor at Cass Business School -

In the concluding session, participants discussed the extent to which corporate governance regulation should be revisioned. As a preliminary question, a participant asked the other experts in the room whether they thought that boards should be primarily focused on steering or supervision. While there was consensus that boards should fill both roles, the difficulty was in gauging the right level of attention to devote to each responsibility.

Governance may have become excessively compliance-driven such that it creates a risk averse culture that stifles value creation, risk-taking, creativity and innovation. Yet markets and regulators may react negatively to boards that deprioritise risk management and boards expose themselves to potential liability for failure to properly fulfill their duties.

Several participants said that we need inspired leadership that creates positive internal culture and understands what drives behaviour at all levels within a company. A number agreed that the current approach fails to look at the drivers that lead individuals to make decisions that cause negative externalities, such as water pollution or the emission of toxic chemicals that contribute to global warming.

One participant thought that positive incentives should not be introduced to foster pro-social behaviour, but rather incentives that promote short-termism should be removed in order to allow individuals to make decisions that will benefit businesses and eventually reduce the need for external regulations. People often want to 'do the right thing' but may be constrained by external factors, peer pressure or simply responding to signals from others ('group think').

Given the need to improve sustainability literacy, core business school education should be reformed to ensure future business leaders have the tools they need to examine how their companies create value and the impacts of their business have on both internal and external stakeholders.

Others disputed the continual emphasis on solutions coming from companies themselves and suggested that regulation needs to be combined with internal solutions. Businesses themselves may benefit from regulations that set clear expectations for behaviour.

There was significant difference of opinion on whether the Corporate Governance Code gave businesses the right level of flexibility to tailor solutions to fit their needs or rather had become dysfunctional. One controversial proposal was to drop the UK Corporate Governance Code in favour of increased reliance on the

seven duties of directors, which are set out in the Companies Act. While others disagreed with scrapping the Code, there was recognition that regulation has multiplied and in many instances become overly process-oriented.

Directors' duties as set out in the Companies Act:

Duty to act within powers (s. 171)
Duty to promote the success of the company (s. 172)
Duty to exercise independent judgment (s. 173)
Duty to exercise reasonable care, skill and diligence (s. 174)
Duty to avoid conflicts of interest (s. 175)
Duty not to accept benefits from third parties (s. 176)
Duty to declare interest in proposed transaction or arrangement (s. 177)

Finally, it was suggested that the fundamental problem with regulation is that it continuously multiplies and becomes increasingly complex to address past events and crises. The current focus on risk management is understandable as it is in reaction to the global financial crisis. Societal expectations of companies have evolved and it may be appropriate to broaden the duties of directors to more explicitly address business impacts.

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