# Corporate Governance for a changing world

Executive Summary

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## Introduction

How should corporate governance contribute to robust long-term value creation for companies? What corporate governance practices can help companies manage and develop intangible assets more effectively? Amidst incredible complexity and increasing societal expectations on corporations, what should society realistically expect from corporate governance with respect to environmental and social issues?

These were the main questions discussed at New York University School of Law on June 11, 2015 by 25 leading corporate governance experts. The roundtable brought together a unique mix of business and law professors, institutional investors, company representatives, and civil society organisations. The event was the second in a global corporate governance roundtable series launched by the Purpose of the Corporation Project. It was co-hosted by NYU Stern and Law, Aspen Institute Business and Society Program, the Conference Board Governance Center, and purpose-driven law firm Frank Bold that initiated the aforementioned project in Europe.

## Unpacking the elements of long-term sustainable value

Filip Gregor, Head of the Responsible Companies Section at Frank Bold, launched the afternoon by noting that the Anglo-American corporate governance model has shaped governance in continental Europe due to the influence of the OECD through its Principles for Corporate Governance and the EU. Now that the financial crisis has revealed weaknesses in this corporate governance model, it is appropriate to have a trans-continental debate about the way forward. He suggested that underlying corporate governance regulation is the tension between short-term and long-term investment: "only short-term is bad, only long-term is bad; it's about striking a balance between the two".

### Intangible assets and economic value

David Langstaff, CEO of Argotyche Inc., asked roundtable participants in the first session to consider how companies should ① account for, ② measure and ③ deliver intangible assets.

Several participants noted that there now exist many metrics for short-term but not long-term value. Current accounting models are limited in terms of what they measure and their time horizons. Environmental, social and governance (ESG) matters have an impact on performance but are mostly qualitative and therefore difficult to measure. It is similarly difficult to measure complex concepts and intangible assets such as resilience, leading most indicators to typically rely on proxies.

There is a constant trade-off between simple and easy to use quantitative indicators and relevant, high quality qualitative indicators. For example, ISS's quantitative model is easily comparable and useful for busy asset managers but lacks a nuanced analysis and may ultimately direct our focus towards what is readily counted rather than what counts. Yet the reality of high-frequency trading must be acknowledged, which increases the pressure on boards and firm leaders to focus on financial indicators.

One discussant pointed out that the debate how to measure non-financial assets dates back several decades. The balanced scorecard approach developed by Kaplan was widely used in the 1980s and 1990s and could

[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)

be a useful model for combining financial and non-financial metrics (see Kaplan and Norton, 2001). Other non-financial metrics are being developed by organisations like the Drucker Institute and the Sustainability Accountability Standards Board (SASB).

On the other hand, a participant asked whether the ultimate goal is to put a financial value on intangible assets at the company level, and whether it should be? A number of participants noted the importance of telling a compelling story about the company's long-term strategy. Many investors appreciate having direct conversations with the leadership team about where the company is headed; this may be more informative than relying on imperfect metrics.

It was asked what must change and where to start with this transition: how should we reward a company for good governance? One participant suggested that it may be necessary to change stock exchange rules or other regulations in order to give companies the space to reap the reward of long-term investments and doing the 'right thing'. Another suggested changing the tax code to create incentives for holding shares long-term, e.g. by reducing capital gains tax payable on shares held long-term, as has been urged by BlackRock's CEO (see Sorkin, 2015). Investors may also play a role here; one investor in the room had put forward a shareholder resolution to split the CEO and Board Chair positions in order to push the relevant company to overhaul its governance structure and take responsibility for a human rights disaster in which the company had been implicated. Similarly, investors (and regulators) ask for detailed information about top executive compensation without requesting any details about the salaries of workers at the bottom.

The question was posed whether the problem of how to promote responsible business is a structural issue or a behavioural one. Participants agreed that tone from the top is important as it creates brand and trust, CEOs that recognise the value and importance of sustainability need to communicate proactively with employees and shareholders to embed this way of thinking into the corporate image. One participant suggested that the root challenge is that the shareholder primacy model of corporate governance perceives expenditures on intangibles such as human capital to be a waste of shareholder assets and consequently not made a priority by many business leaders.

## Environmental and social value

In the second session, Karen Brenner, Executive Director of Law and Business Initiatives at NYU asked the room to consider what society should realistically expect from corporate governance with respect to environmental and social issues.

Michael Posner, Professor of Business and Society at NYU then provided context for the discussion, noting that corporate social responsibility (CSR) is not central to business strategy and identifying the need for industry-specific identification of human rights risks. For example, the food and beverage industry is plagued by issues relating to agricultural sustainability and working conditions, especially of migrant workers, and these issues should be reflected in any human rights standard used to judge that industry's performance. Prof. Posner suggested that benchmarks should look at outcomes in addition to process and commitments. In other words, "trust, but verify", as we are past the point when all companies can be on a journey to human rights and they should therefore be judged on their outputs.

There may also be a place for voluntary industry initiatives. For example, the Private Military Code gives guidance on the use of force while Oxfam's Behind the Brands scores the ten largest food brands on a range of food justice issues, including water, land and climate change. Ideally investors should be pushing firms to engage constructively with human rights issues. Consumers will also drive the shift to real sustainability by picking competitors who rate well on various indicia. The Shift Project has developed a corporate human rights benchmark designed to measure performance against the core human rights instruments (known as RAFI).

Governments are beginning to demand more information from their own companies, although they continue to lag at adequately respecting and enforcing human rights standards. The primary emphasis is on disclosure of risk, e.g. the US Dodd Frank Act requirement to disclose information on conflict minerals, the UK's Modern Slavery Act, and the EU Non-Financial Reporting Directive. Each of these legislative instruments contains detailed disclosure requirements but has limited provision for monitoring or enforcement.

# Exploring solutions

## Future Scenarios

Participants engaged in a backcasting exercise led by Rick Wartzman, Executive Director of the Drucker Institute where they were asked to design a corporate governance innovation to address a challenge facing a mock company (see e.g. Quist and Vergragt, 2006 for an explanation of backcasting). Each group was asked to assume a different position (CEO, board of trustees/directors, institutional investor) and then tackle a different environmental or social challenge to prompt reflections on how to stimulate positive changes through corporate governance in the next five years.

The group playing the role of institutional investor on the board of a public company explored various options for increasing their influence, including creating an investor role on the board (along with a directorship for stakeholders), an investor advisory committee to the board (similar to technology, Silicon Valley advisory committees) or shifting to a principles-based disclosure regime in place of the current rules-based one. The group eventually decided instead to stagger the board and extend the length of term for each director from annual elections to three to five year terms with a reasonable recall trigger. The thinking was that annual elections add some accountability but they create a 'campaign mentality' that prevents directors from focusing on long-term value creation.

Another group wished to encourage long-term investors by creating different classes of dividends. They decided to create time-weighted dividends with increasing payments made to investors that remained for the long-term, as compared to current dividends that pay out a flat per share amount to all shareholders regardless of the length of time of their shareholding. Introducing time-weighted dividends would be easiest for private companies at the moment of listing as their decision would be protected by the business judgment rule as well as state law, federal law and stock exchange listing rules (see Belinfanti, 2014: 850- 52). For public companies, it would likely be necessary for these firms to first go private before relisting, or amend existing listing rules, before this innovation could be adopted.

The group representing senior management explored the implementation of a compensation system for managers that would emphasise intangible assets and ESG matters. A key element of this innovation was the connection with long-term risks and opportunities. A well-functioning compensation system should go hand-in-hand with a defined long-term business strategy and the integration of sustainability. In this respect, it would incentivise as well as depend on a functional collaboration between the board of directors and senior executives.

The group representing regulators focused on a flexible but mandatory system for the disclosure of ESG matters by public corporations. Such a system would be designed in a way to create a safer space for exploring disclosure by corporations and would aim to facilitate the debate between corporations and long-term investors, in particular institutional ones. Similarly to the discussion in the previous group, the discussants emphasized the connection of ESG disclosure to long-term corporate strategy.

**Additional innovations that were explored:**

- Loyalty shares, which could encourage long-term investing by giving shareholders a reward after a pre-determined time period, such as by giving investors the right to buy additional shares at an advantageous price or granting special bonuses (see Peterson, 2011).

- Dual-class share structures, which have been widely used by the founders of US technology firms such as Google and Facebook to retain decision-making authority while bringing on board capital from external investors.

## How can we get there?

Lynn Stout, Distinguished Professor of Corporate and Business Law at Cornell Law School, asked the room what can be done by the experts in the room to create momentum for potential reform. Prof. Stout inquired whether there might be a role for non-traditional corporate governance actors, such as labour, consumers, academics, socially responsible investors (SRIs) and proxy advisors.

It was suggested that the framing of the future of corporate governance should deliver a positive message, i.e. that good business behaviour is a win-win that will translate into strong financial performance over the long-term (see e.g. Mitchell et al. 2015). The goal should be to create a 'race-to-the-top', not necessarily to criticize poor performers or resort to an adversarial position vis-à-vis companies that lag behind. Another participant, however, suggested that the use of 'sticks' in addition to 'carrots' should not be underestimated and that there may be value in trying to measure and evaluate the companies that do not perform well. More work is needed to foster an environment where companies feel free to step up to the table to address their impact. We should be positioning sustainability as an opportunity for companies to reduce risk in the face of looming crises, such as climate change, that will have a detrimental impact on businesses that fail to adapt. Institutional investors could be a key avenue to bring CEOs to discussions of how to address these issues.

**Several concrete proposals for next steps emerged, including:**

- Mapping institutions and organisations that are already taking on the challenge of addressing short-termism in order to identify key players.
- Mobilising allies quickly to respond to current events with op-eds and media interviews explaining how the events relate to underlying structural issues, e.g. how an eventual future financial crisis is tied to the failure to overhaul the regulatory system. This could be done through a listserv or a loose network of scholars, such as been assembled by Dr. Jeroen Veldman of Cass Business School.
- Strengthening connections between socially responsible investors and civil society organisations as a coordinated effort.
- Convening institutional investors at the CEO level to align interests and as a group create pressure for long-termism.

## Final thoughts

Donna Dabney, Executive Director of the Conference Board Governance Center, wrapped up the session by noting that the quest to create metrics for intangible assets goes back decades to the balanced score card of yesteryear. Institutional investors have said 'enough metrics, tell us your story'.

Multiple participants suggested that sustainability will become imperative for growth in the near future, not a value-add or a risk management issue. Currently, however, there continues to be a disconnect between the rhetoric in support of investing in sustainability and long-term value creation, and actual investment practice. Large institutional investors have begun to establish dedicated ESG units but these arguably remain marginal to their conventional investment activities, which continue to focus first and foremost on traditional financial indicators. It was suggested that regulatory intervention might be necessary to address this inconsistency. As one participant noted, “we are trying to jumpstart a cultural change”, which requires a multi-prong approach of both voluntary and regulatory initiatives.

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