RESPONSE TO THE UK GOVERNMENT GREEN PAPER "CORPORATE GOVERNANCE REFORM"

Radix Paper No. 6

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RADIX

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BEYOND GOVERNANCE: TOWARDS A MARKET ECONOMY THAT WORKS FOR EVERYONE

"The love of money as a possession – as distinguished from the love of money as a means to the enjoyments and realities of life – will be recognised for what it is, a somewhat disgusting morbidity, one of those semi-criminal, semi-pathological propensities which one hands over with a shudder to the specialists in mental disease."

JOHN MAYNARD KEYNES

“[It is] time to stop thinking about corporate governance and executive pay as matters of equity and to regard them instead as a macroeconomic problem of the first rank.”

ROBIN HARDING

“We can not solve our problems with the same level of thinking that created them”

Albert Einstein

BEYOND GOVERNANCE
TOWARDS A MARKET ECONOMY THAT WORKS FOR EVERYONE

Response to the UK government's green paper "Corporate Governance Reform" published in November 2016

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WHAT'S IT ALL ABOUT?

"This government will build an economy that works for everyone not just the privileged few."

In November 2016, the UK government issued a green paper titled "Corporate Governance Reform". The above quoted words from the Prime Minister, the Rt Hon Theresa May MP, set the scene as to what the government is intending to achieve through its corporate governance reform. It is a bold aim and one that, one would hope, would find widespread support.

BUSINESS HAS A BIGGER ROLE TO PLAY THAN MERELY MAXIMISING SHAREHOLDER VALUE

This paper is intended as a response to the green paper and puts forward suggestions for the government to consider as part of its plans. In doing so we have to keep the Prime Minister's words in mind. Reforming corporate governance is not an end in itself. It's about clearly defining the vital role that we would all like business to play not just in our economy but more broadly in our societies. The idea that business has a broader and more important role to play than simply maximizing shareholder value. It is about what Simon Zadek calls *"the evolution of corporate governance away from intensive towards an extensive accountability, embedded within a 'public fiduciary"*[1]. In other words, business that has a broader fiduciary duty towards all members of our society.

To put it another way, *"We seem to have forgotten that the only reason we seek economic success is to continue to improve the condition of people's lives and to enable us to build the sort of societies we want to live in. Economic success is not an end in itself, it is merely the route to personal and social wellbeing."*[2]

It is tempting to see corporate governance reform as a process designed to bring big business to heel or to control the excesses of the few. *"In recent years, the behaviour of a limited few has damaged the reputation of the many"* according to the Prime Minister's introductory remarks. Yet this is far too narrow a lens with which to approach corporate governance. Corporate governance is one of the elements that shapes our economy and our society. Effective reform should not primarily be driven by the regrettable actions of the wayward few but rather by the opportunities that the many can provide if the legal and institutional frameworks drive in the right direction.

> Reform should be driven by the opportunities offered by the many not simply by the desire to contain the wayward few

The government should be clear that it is time to *"stop thinking about corporate governance and executive pay as matters of equity and to regard them instead as a macroeconomic problem of the first rank."*[4] The government's reform efforts should therefore be front and centre of government policy making.

If we look at the issue through that broader lens, it becomes clear that corporate governance reform will not, on its own, achieve the stated aim of an economy that works for everyone. However, it is a vital component of that journey. While the primary focus of this publication is the green paper, a broader view is therefore taken. Some other, related areas that the government should consider if it is to achieve its stated aim are also put forward

IT'S ALL ULTIMATELY POLITICAL

We should also bear in mind that the desire to create an economy that works for everyone is a political not a financial or business objective. As one moves to design and implement any kind of reform, this creates a possible gap between the views and objectives of government – that will view the issues through a political lens – and industry leaders and investors – who will view the issue from a financial and business perspective. As one British business leader put it to the author recently: *"Politics operates to a different kind of rationality than business and, frankly, we don't understand it."*

> Corporate governance and executive pay are macroeconomic issues of the first order

This creates a substrate for potential confrontation. However, while politicians need to, and (at least some) obviously do, bear in mind that without successful enterprise there is no wealth creation to be distributed to the population, business leaders also need to internalise that, in a functioning democracy, political objectives must always have primacy over narrow financial interests. This sometimes gets lost as evidenced by a question to the author by one senior banker: *"What can we do to get politicians out of the way of us getting on with doing business?"*

AN OPPORTUNITY THAT SHOULD NOT BE MISSED

Corporate governance reform offers an opportunity for the government to start to move towards its stated aim of creating an economy that works for everyone. How extensive and meaningful any eventual reforms will turn out to be will give voters a clear view as to whether the government is indeed serious about its stated aim or whether changes will be purely cosmetic and we will largely carry on with business as usual.

The author wishes the government well in its endeavours towards building an economy that works for everyone.

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1. ANSWERS TO QUESTIONS POSED IN THE GREEN PAPER

This section provides the headline recommendations framed as answers to the questions posed in the green paper. Clearly, many of the questions require more nuanced answers than are provided in this summary section. More explanation, counter-arguments and qualifications to the answers provided here are to be found in the main body of the paper.

CATALOGUE OF GREEN PAPER QUESTIONS

EXECUTIVE PAY

CONSULTATION QUESTION

1. Do shareholders need stronger powers to improve their ability to hold companies to account on executive pay and performance? If so, which of the options mentioned in the Green Paper would you support? Are there other options that should be considered?

A: There may be little harm in increasing shareholder powers. But this will not achieve the stated intent of the green paper and is therefore probably pointless. "Shareholders" is a catch-all term that is largely meaningless. It covers a varied population of individuals, institutions and financial intermediaries all with different interests and objectives. The idea that these can act in concert with one single objective in mind is not credible.

See Section 5.2 of this paper.

CONSULTATION QUESTION

2. Does more need to be done to encourage institutional and retail investors to make full use of their existing and any new voting powers on pay? Do you support any of the options mentioned? Are there other ideas that should be considered?

A: As above

CONSULTATION QUESTION

3. Do steps need to be taken to improve the effectiveness of remuneration committees, and their advisers, in particular to encourage them to engage more effectively with shareholder and employee views before developing pay policies? Do you support any of the options set out in the Green Paper? Are there any other options you want to suggest?

A: Yes, effectiveness of remuneration committees clearly need to be improved. But the government cannot micro-manage these issues. A better approach lies in creating a regulatory regime that is stringent enough that it encourages company boards to take their own initiatives in improving the work of remuneration committees and what they expect of their advisers. The main issues are complexity and misaligned incentives. These should be the focus of any reform. A professional standards body focused on governance could work with companies to encourage the spread of best practice.

See Section 5.4 of this paper.

CONSULTATION QUESTION

4. Should a new pay ratio reporting requirement be introduced? If so, what form of reporting would be most useful? How can misleading interpretations and inappropriate comparisons (for example, between companies in different sectors) be avoided? Would other measures be more effective? Please give reasons for your answer.

A: Publishing of pay ratios is fraught with difficulty in meaningful implementation and interpretation. It will achieve very little except a lot of vituperative column inches.

CONSULTATION QUESTION

5. Should the existing, qualified requirements to disclose the performance targets that trigger annual bonus payments be strengthened? How could this be done without compromising commercial confidentiality? Do you support any of the options outlined in the Green Paper? Do you have any other suggestions?

A: The most effective approach is to explore ways to de-link executive compensation from short-term stock price performance – a system that benefits neither those shareholders who are interested in sustainable company performance, nor business, nor society.

All the accumulating evidence shows that performance-related pay decreases rather than increases performance and encourages unethical behavior. Large components of compensation packages linked to performance should therefore be heavily discouraged.

See Section 5.4 of this paper

CONSULTATION QUESTION

6. How could long-term incentive plans be better aligned with the long-term interests of quoted companies and shareholders? Should holding periods be increased from a minimum of three to a minimum of five years for share options awarded to executives? Please give reasons for your answers.

A: Executive pay packages need to be both simplified and aligned with the longer-term interest of corporations, stakeholders and the economy.

- *The simplest and likely most effective approach would be to require that executives are paid in cash and stock with a long holding period and without any performance related bonuses*
- *Awarding stock rather than options would increase transparency but this is not facilitated by the current UK tax system*
- *Options should have a minimum vesting period of five years; no accelerated vesting should be allowed; on change of control, options should not vest but should be substituted with options in the new entity with the vesting period starting from scratch*
- *Another approach is to require that the same compensation principles (though, clearly, not the amounts) should be uniform across all company employees. This would allow companies to make their own choices of compensation methods while ensuring that there is no continued divergence between executive pay and employee remuneration. They would move in sync and remuneration packages would, by necessity, need to be more transparent.*
- *Large scale stock repurchase schemes should be made illegal – just as they were in the US before 1982*

See Section 5.4 of this paper.

STRENGTHENING THE EMPLOYEE, CUSTOMER AND WIDER STAKEHOLDER VOICE

CONSULTATION QUESTION

7. How can the way in which the interests of employees, customers and wider stakeholders are taken into account at board level in large UK companies be strengthened? Are there any existing examples of good practice that you would like to draw to our attention? Which, if any, of the options (or combination of options) described in the Green Paper would you support? Please explain your reasons.

A: A number of actions could be taken to drive change:

- *Company law should be modified to give company directors responsibility for looking after the interests of all stakeholders rather than privileging shareholders over all other stakeholders*
- *Companies should be required to provide Integrated Reporting or Impact Reporting' on at least an annual basis*
- *A professional standards body could collect and spread best practice across companies*
- *New company forms (B-Corporations) should be enshrined in company law*
- *Directors who repeatedly fail good corporate governance standards should be banned from holding company directorships for a minimum period of five years*

See Sections 3 and 4 of this paper

CONSULTATION QUESTION

8. Which type of company do you think should be the focus for any steps to strengthen the stakeholder voice? Should there be an employee number or other size threshold?

A: All firms (of whatever legal form) with more than 500 employees – including firms that, in effect, 'employ' more than 500 people while not listing them as employees.

See Section 4.2 of this paper

CONSULTATION QUESTION

9. How should reform be taken forward? Should a legislative, code-based or voluntary approach be used to drive change? Please explain your reasons, including any evidence on likely costs and benefits.

A: This should not be an either/or question. A mix of both is likely to be required. More important is to establish a mix of top-down and bottom-up regulation.

See Section 3 of this paper.

CONSULTATION QUESTION

10. What is your view of the case for strengthening the corporate governance framework for the UK's largest, privately-held businesses? What do you see as the benefits for doing so? What are the risks to be considered? Are there any existing examples of good practice in privately-held businesses that you would like to draw to our attention?

A: Size, not the legal form of a firm, should be the primary determinant (see answer to Q8). There is no valid reason why the chosen corporate form should be a determinant of whether good governance is desired. Size is a better determinant for two main reasons:

- The evidence shows that size in the primary determinant of whether firms provide benefits to their communities or not
- Larger firms have the resources to deal with the more stringent regulatory requirements that would be a significant burden for smaller firms

CONSULTATION QUESTION

11. If you think that the corporate governance framework should be strengthened for the largest privately-held businesses, which businesses should be in scope? Where should any size threshold be set?

A: See answer to Q8

CONSULTATION QUESTION

12. If you think that strengthening is needed how should this be achieved? Should legislation be used or would a voluntary approach be preferable? How could compliance be monitored?

A: Integrated Reporting should be a legal requirement for all large firms. Monitoring of corporate governance standards should be the responsibility of a professional standards body

See Sections 3 and 4.2 of this paper

CONSULTATION QUESTION

13. Should non-financial reporting requirements in the future be applied on the basis of a size threshold rather than based on the legal form of a business?

A: See answer to Q8

OTHER ISSUES

CONSULTATION QUESTION

14. Is the current corporate governance framework in the UK providing the right combination of high standards and low burdens? Apart from the issues addressed specifically in this Green Paper can you suggest any other improvements to the framework?

A: The answer to this question depends on the primary objective that the government is trying to achieve:

- If the primary aim is, as stated by the Prime Minister, 'to achieve an economy that works for everyone rather than just the privileged few', then the current framework is clearly inadequate

- If the belief is that well-governed firms create more long term value for the economy and society (even at some short-term cost), then the primary aim becomes to build a business culture in the UK that is at the forefront of global developments in governance. The current framework does not reflect emerging best practice in global governance.
- If the primary aim is to position the UK as a place that attracts business investment by setting the lowest regulatory burdens (a race to the bottom), then the current regime probably does that or can be loosened further.

High standards and low burdens work in opposite directions – whether those burdens are statutory or self-imposed by firms. The appropriate balance is a matter of which primary objectives the government wants to achieve.

OTHER RECOMMENDATIONS NOT COVERED BY GREEN PAPER QUESTIONS

- *To move towards an economy that works for everyone, government should set a Gini Policy: a target Gini coefficient it is trying to reach*
- *The corporate governance framework should be based on a template on the type of companies and behaviours that the UK would like to build for a successful 21st century economy*
- *To provide predictability and regulatory stability for business, the government should lay out a clear long-term trajectory for its corporate governance ambitions. Even if changes are introduced in a staged fashion, they should follow a clear and consistent long-term direction*
- *Any corporate governance framework should be reviewed and updated every three years*
- *Government should use its soft powers (eg. 'naming and praising', the Honours system, and the award of any government contacts) to reward high standards of corporate governance*
- *Corporate governance standards could be a component of any future public interest test for foreign takeovers*

2. REFORM: FRAMEWORK, OPPORTUNITIES AND ROAD BLOCKS

Many of the issues that the government is trying to resolve are based on cultural and structural factors affecting the UK. They do not all easily lend themselves to quick technocratic solutions. Economies and societies are complex systems. Linear thinking and linear solutions do not work in complex systems and generally tend to make things worse. Government is well placed to drive change. But only if issues are recognized for what they are – complex cultural and structural issues that require sustained pressure in a consistent direction. They are not simple problems that are amenable to a quick fix with the odd piece of legislation and a few voluntary but unenforceable agreements put together to fit the electoral cycle.

Since the financial crash, *"The economic policy debate in both the political and academic worlds has centred almost exclusively around short-term demand management issues rather than on how, as a country, we can raise long-term productivity and create sustainable growth."* according to former Secretary of State for Business, Innovation and Skills, Sir Vince Cable[4]. However, Cable continues by describing his experience in government and what was achieved: *"This experience persuades me that it is possible to swim against a tide of pessimism and low expectations."*

> Effective reform is possible. But does the government want it enough?

In that context, how effective any reform will turn out to be can be taken as being simply a measure of two factors. First, whether the government looks at corporate governance reform through the broader lens of the structure and culture of the UK economy rather than as a narrow exercise resulting in tinkering around the edges. Second, whether the government is determined to address some of the underlying fundamentals and has high expectations as to what is possible to achieve.

Real, long-lasting reform is not impossible. But does the government want it enough? And is meaningful reform by the current government politically feasible given the powerful forces that may align against it?

2.1 WHAT HAS BEEN DONE SO FAR?

In his Foreword to the green paper, the Secretary of State for Business, Energy and Industrial Strategy, the Rt Hon Greg Clark MP, states:

> *"One of the reasons why we have maintained such a reputation [for being a dependable and confident place in which to do business] is that we have kept our corporate governance framework up to date – with reviews and improvements made from time to time such as those made by Cadbury in 1992 and Greenbury in 1995."*

A number of other initiatives have been implemented since 1995 that have a direct or indirect impact on the framework of corporate governance.

The Companies Act 2006 broadened directors' responsibilities to have regard for stakeholders other than shareholders. This was a significant and welcome step. By the green paper's own admission, its impact has been insufficient and the green paper calls for suggestions for how management can be encouraged to do better.

The green paper also outlines the reforms that were implemented in 2013, mainly focused on executive pay. Given the short time frame since their implementation, it is hard to make final judgements on the effectiveness of the reforms.

> Empowering shareholders is not the answer to corporate governance failures

Many of the reforms followed the publication of the Kay Review[5] on UK equity markets which addressed the plague of chronic short-termism (see Section 2.3). Much happened in its wake[6] with the publication of an updated Stewardship Code by the Financial Reporting Council, the use of an Investor Forum, discussions on transparency of executive pay and many other initiatives that interested readers can review for themselves. The Review noted that meaningful change would take time.

However, the Review was also narrow in its scope in that it focused on equity markets and the role of investors.

The green paper notes that since the reforms, most companies received approval of executive pay packages from shareholders. This can be interpreted in two ways. Either that the reforms are working and pay packages are now reasonable; or that delegating oversight of executive pay solely to shareholders simply doesn't work. This paper takes the second view (Section 5) and puts forward the evidence in support of that position. To give just one reason here, Colin Melvin, chief executive of Hermes EOS, which represents institutional investors worldwide, claims that many chief executives and other top managers struggle to understand what is in their pay packages or how to hit their targets[7]. If managers cannot understand their own pay packages, it's a bit of a stretch to believe that remote and highly varied shareholders can make credible judgements on executive pay packages. Neither does the reductionist idea of providing directors' pay information in a single figure (as is now required) solve this issue.

2.2 DEVELOPING A PROCESS THAT WORKS

Britain has traditionally operated an adversarial political environment.

> An adversarial political and industrial environment is a driver behind the UK's low productivity.

We suggest that this embedded adversarial environment is a factor driving the consistently poor productivity in UK industry and the UK economy in general. Countries that operate a more consensus based culture are better able to muster their resources all to push in the same direction with consequent improvements in productivity. Of course it's not that simple in that productivity is both multifactorial and current measures are probably outdated for an information age. Yet, an adversarial approach is more likely to hinder than help overall productivity.

For this reason, the government should consider a more consensus based process around its proposals for corporate governance reform. Rather than the usual method of producing green and white papers and asking all parties to produce their own separate, and often conflicting, responses and intense lobbying efforts with the government sitting as ultimate arbiter, there is room to bring all parties together and requiring them to produce joint, mutually agreed proposals based on collaborative discussion. The government's role changes from that of ultimate arbiter to one that bangs heads together and is uncompromising in demanding and facilitating consensus-based constructive suggestions.

> A consensus based approach to developing a corporate governance framework would be more effective

In that spirit, the suggestions put forward in this paper are intended as a platform designed to generate discussion. A discussion in which it is hoped that those on all sides of the various arguments will join in a constructive fashion.

2.3 EMBEDDED SHORT-TERMISM

The UK economy also suffers from a deeply embedded short-termism.

Such short-termism is explicitly recognized in the government's green paper. This paper argues that one of the major drivers of such short-termism is the relentless focus in the UK on the primacy of "shareholder value" – a concept that is becoming increasingly discredited and has been described as *"an abstract economic theory that lacks support from history, law or the empirical evidence"*[8]

Section 4 of this paper argues that the UK would be better served by moving to a stakeholder economy. Absent such a move, not only will corporate governance likely remain inadequate but the UK economy will, over time, likely fall behind other economies and continue to exhibit high levels of inequality. The economy will not work for everyone.

THE AUTHOR HAS RECENTLY BEEN INVOLVED IN RAISING VENTURE FINANCE FOR AN EARLY STAGE COMPANY. MOST OF THE ACTIVITY WAS FOCUSED ON THE UK VENTURE CAPITAL MARKET.

ON VISITING A DUTCH INVESTMENT HOUSE THEIR FIRST COMMENT WAS "WHY IS THERE ALL THIS TALK OF EXIT IN YOUR MATERIALS? WE LIKE TO FOCUS ON BUILDING GREAT COMPANIES THAT CAN BE SUCCESSFUL FOR THE LONG TERM. WE'RE NOT INTERESTED IN EXITS. WE FUND OUR NEW INVESTMENTS FROM DIVIDENDS OF COMPANIES SOME OF WHICH WE HAVE HELD FOR THIRTY YEARS."

IT IS INCONCEIVABLE TO HAVE THAT SORT OF CONVERSATION WITH A UK BASED VENTURE FUND.

3. HOW SHOULD CHANGE BE ACHIEVED?

IF YOU THINK THAT STRENGTHENING [THE CORPORATE GOVERNANCE FRAMEWORK] IS NEEDED, HOW SHOULD THIS BE ACHIEVED? SHOULD LEGISLATION BE USED OR WOULD A VOLUNTARY APPROACH BE PREFERABLE? HOW COULD COMPLIANCE BE MONITORED?

Question 12, page 14 of government's green paper

The question of voluntary codes as against statutory regulation raises its head every time any kind of reform is being considered. Predictably, those on whom regulation would have an impact consistently tend to argue for a voluntary approach. Others argue that only statutory measures can possibly have a meaningful impact.

We suggest that this need not be an "either/or" question but rather trying to find the combination of instruments that is most likely to be effective. There is no doubt that some voluntary agreements (such as gender diversity on boards) have shown success over the years, while others (such as press regulation) have not. Similarly, the legislative route is no guarantee of success. Whole industries exist whose function it is to keep individuals and organisations within the letter of the law while finding ways to undermine its spirit and render it useless in practice.

The government also needs to keep in mind that its stated aim is one of perceived fairness. Over the years, successive governments have been eager to reach for legislation as their route to controlling trade union activity. There has not been much talk of voluntary agreements as a way forward. If the government is not to be perceived as treating one group (workers and their representatives) differently to others (businesses and senior executives), then it needs to develop and be seen to implement a consistent approach towards all groups.

We suggest three themes in constructing an overall approach:

- *Regulation is a public good – and needs to be forward looking*
- *The need for regular review*
- *Meaningful monitoring, rewards and penalties*

3.1 REGULATION IS A PUBLIC GOOD

Those on the Right of the political spectrum have, since the Thatcher/Reagan era, decided to equate regulation with 'red tape'. They have mounted a war on regulation and turned de-regulation into a religion. This attitude leads to the reluctance to implement any statutory measures – or in fact for government to do anything much except de-regulate.

Yet, such an attitude is thoughtless myopia that has made caricatures of its most vociferous proponents. How many of those who would take up arms in the 'war on red tape' would themselves happily fly with an airline that, if that were possible, decided to opt out of all airline safety regulations? How many would put their money or investments with a totally unregulated bank of investment house? Or give their children unregulated pharmaceutical products?

Regulation is a public good. It is intended to protect citizens from the worst excesses of human behaviour that are intended to favour the few at the expense of the many. True, regulation, like almost everything, is difficult to get right. But one of the reasons is that regulation is often backward looking rather than forward looking. It is often a reaction to things that have gone wrong and results in shutting the door after the horse has bolted. Yet, approached with the right mindset, regulation has the potential to make industry more competitive and more forward looking.

FORWARD LOOKING

For this to work, the question needs to be reformulated from *"How do we stop bad behaviours?"* to *"What type of companies and what type of industries do we wish to develop in the future and how can regulation be used to drive our economy in that direction?"* This approach is particularly relevant to corporate governance reform. It offers the opportunity for Britain to encourage the creation of the best companies and the best industries. How that might be done we address in later sections.

PRINCIPLES BASED REGULATION

Britain has also had a tradition of principles based regulation as opposed to the US preference for rules based regulation. Experience has shown that principles based regulation is significantly more effective since it allows interpretation of specific behaviours within the framework of the principles that are meant to be upheld. It is also provides more flexibility to allow different interpretations for companies that find themselves in different circumstances. Rules, on the other hand, can never cover all eventualities and are much easier to circumvent. They also tend to tie all companies up in the same rules even when their businesses are fundamentally different.

HOW REGULATION ACHIEVES CHANGE

There are two approaches to regulation that is designed to achieve positive change. But these two forms are not, as the green paper suggests, legislation versus voluntary agreements – that's the wrong framework. It's top-down versus bottom-up.

The first approach assumes regulation to be a process of top-down control – the imposition of ways of doing things accompanied by penalties for non-compliance. This is the most common form – and the form assumed when anyone talks about red-tape. It is an essential form of regulation. But as outlined above, it also has limitations limited in effectiveness and it is the type of regulation that most people rail against.

> Given the right regulatory framework, most people will do the right thing

But there is another approach. Regulation that creates the conditions for the desired behaviours to emerge spontaneously. This is less widely practiced and most regulators don't approach regulation with that bottom-up mindset. But such an approach is much more powerful in achieving systemic change through emergent effects. It does require a belief in people – that given the right conditions many, or maybe most, people will do the right thing – and that eventually that 'right thing' will become the social norm. In the current context of an economy that works for everyone, such an approach has an important role to play.

To achieve the government's stated objectives, it is likely that a combination of both forms will be required. It would be a mistake to focus exclusively on one or the other. This paper offers suggestions for both approaches.

Further, bottom-up regulation is likely to require legislative change since this is what will create the conditions for positive behaviours to emerge. Voluntary agreements are merely a soft form of top-down control.

WE THEREFORE RECOMMEND THAT:

- *the corporate governance framework should be based on a template on the type of companies and behaviours that the UK would like to build for a successful 21st century economy*
- *any corporate governance framework should be based on clear and enforceable principles rather than on detailed rules*
- *a mix of 'top-down' and 'bottom-up' regulation is likely to be most effective. This will require both voluntary agreements and legislation.*

3.2 REGULAR REVIEW

No regulation and no incentive system can be perfectly designed to work first time around. There will always be loopholes and imperfections. And they will be exploited. To be successful in adaptive systems, regulation needs to be constantly reviewed and updated.

A STEADY TRAJECTORY

Corporations rightly complain of ever-changing regulation that makes it difficult for them to run their business effectively. This need not be the case. Regulation that clearly defines long term direction and the underlying principles on which that is based gives clarity and stability to business. How individual rules may change to meet the challenges of a changing world becomes less of an issue if the direction is consistent. In such an environment business leaders who show a commitment to travel in the desired direction will do better than those whose sole commitment is simply to meet minimum requirements and to put more resources into circumventing regulatory intention.

> Business needs regulatory stability. This calls for a regulatory framework that evolves in a consistent direction.

One also needs to bear in mind that deregulation can be just as disruptive to business as regulation itself. Businesses still need to change and adapt. Those most heavily penalized by deregulation tend to be those who have already built better, more socially responsible businesses. The laggards emerge victorious. This is one of the reasons why the CBI has called not for deregulation but for 'regulatory stability.'

- *any corporate governance framework should clearly lay out the long-term trajectory the government wishes to pursue. This will give business a clear and stable direction in which it needs to evolve*
- *changes should be introduced in a staged fashion to allow business time to adapt and to allow the government to make changes as unintended consequences arise and as one observes how some choose to circumvent the rules*
- *to allow for such constant evolution, the corporate governance framework should be reviewed and updated every three years. Such a commitment to regular review and improvement should be enshrined in legislation.*

3.3 MONITORING, REWARDS, AND PENALTIES

No regulation can be effective without a mechanism for monitoring progress and without meaningful rewards and penalties being in place.

One approach is to set up an independent regulator to monitor compliance. While this has attractions, it also has disadvantages:

- *regulators can become politicized and end up shifting approach with the political wind*
- *regulators almost always feel the need to measure their performance as a way of showing progress. This results in reductionist performance measures that often create perverse incentives and can end up as bureaucratic box-ticking exercises that add little value*
- *regulators' own incentives tend to push towards a conservative, low-risk approach. This is not what is required. What is needed is an environment that encourages experimentation and exploration of new approaches, even if some of those experiments don't quite work out – as is inevitable*

We have all seen this happen in various sectors and in different ways. Rather than an 'independent' regulator, it is therefore suggested that:

- *industry and its stakeholders should be required to set up an independent Governance Standards Body (GSB) focused on improving standards of corporate governance*

> All stakeholders should be well represented on a Governance Standards Body

The model would be that used to monitor accounting standards, medical standards, standards of legal practice, etc. But with one big difference: such a body would be comprised of representatives from all stakeholder groups as well as one or more individuals who could bring the political/government perspective. This would also go some way towards the previously mentioned objective: trying to bring all parties around the same table and benefiting from the different perspectives that this would bring. A GSB totally controlled by business and comprised exclusively of industry leaders or others who bring purely business and investment perspectives would be neither appropriate nor effective. Such a body would not command the respect and trust of the public. It would simply be seen as another stitch-up – which it would be.

The approach outlined here is probably preferable to the previously suggested approach of placing more stakeholder representatives on company boards. But only if stakeholders truly have a strong voice within a GSB.

COMPLIANCE AND LEARNING FROM BEST PRACTICE

Of course, the first task of a GSB would be to monitor compliance with any eventual legislation and Code of Practice (or even to generate such a code of practice). However, such a top-down approach cannot be the sole focus of a modern regulator.

An effective body would encourage exchange of ideas among corporations. It would have a facilitating role to help companies learn from others how to do things better. The GSB would have a duty not simply to dictate but to learn from best practices in the business world and to use such best practice to further improve the governance framework. This is one of the components of the 'bottom-up' regulation mentioned earlier.

That there is much to learn from best practice is reflected in the government's call in its green paper for examples of good practice that could be drawn to its attention.

Of course, to be effective, such a body needs to be robust and willing to take on vested interests and challenge corporate laggards. To achieve this, it needs the full support of the government and regular government oversight to discuss and evaluate effectiveness.

NAMING AND PRAISING

There are already many companies whose corporate governance practice is exemplary. A GSB could usefully identify such companies and publicise their efforts in a *"Naming and Praising"* approach that would be a welcome addition to the current negative naming and shaming approach which seems to be becoming the favoured method.

Once again, this is a way of enabling and encouraging emergent good practice.

USING THE HONOURS SYSTEM

> Leaders deserve honours for how they have run their companies not just for getting the job

Another approach to encouraging emergent good practice is for the government to use its softer powers to change culture and to encourage appropriate behaviours. For instance, the current honours system seems to reward individuals simply for reaching a certain leadership position in industry irrespective of their performance in the job. We have seen the failures of this system in the banking, retail and other sectors with MPs calling for honours to be withdrawn.

Would a better approach not be to award honours to those who have shown exemplary leadership in how their companies are run? In selecting such candidates, their performance in corporate governance matters should play a leading role. It would spare us all the disappointment and loss of faith in our highest institutions that naturally arise when those receiving honours are those whose pay packets seem to be the most outrageous or those who proceed to destroy rather than build companies.

Sir Philip Hampton, Chairman of GlaxoSmithKline, goes further. He suggested that that the financial rewards given to senior business people should be sufficient and that they should not, in addition, receive honours. *"I think to get both financial rewards and other recognition is a bit too easy."*[9]

The next section proposes some more specific changes to the legislative framework within which companies operate.

GOVERNMENT CONTRACTS

- *corporate governance standards should be an explicit factor to be taken into account when firms are selected for government contracts*

PENALTIES

The question of penalties for non-compliance is another issue that raises its head with any kind of reform.

It now seems clear that financial penalties imposed on companies are both unfair (they largely penalize stakeholders rather than the management that was responsible for the infractions) and have limited effectiveness (most companies are able to absorb such penalties over time). In the context of the potential criminal fraud related to the sale of sub-prime mortgages that triggered the financial crisis, retired US district judge Jed S Rakoff put it like this:

> *"Companies do not commit crimes; only their agents do. And while a company might get the benefit of some such crimes, prosecuting the company would inevitably punish, directly or indirectly, the many employees and shareholders who were totally innocent. Moreover, under the law of most US jurisdictions, a company cannot be criminally liable unless at least one managerial agent has committed the crime in question; so why not prosecute the agent who actually committed the crime?"*[10]

While this statement does not mention the fact that, in the UK as in the US, some 'sins of ommission' do not, in law, require responsibility to attach to any managerial agent, the statement is directionally correct and valid in most cases. Rakoff goes on to conclude that imposing penalties on companies rather than directors is both morally and technically suspect.

Professor John Kay interprets the nature of the current system in the context of the Roll-Royce £671 million payment to settle allegations of bribery. This 'deferred prosecution agreement' was paid so that, subject to certain conditions, no prosecution would follow.

> Is there one form of justice for ordinary citizens and another for company managers and directors?

> ***Kay asks:*** *"Imagine the reaction if an individual citizen acknowledged that he or she had not only committed criminal offences but paid large sums of money for prosecutors not to initiate proceedings. Yet such behaviour has become the norm for large corporations."*[11]

Both Kay and Rakoff ask the legitimate question as to whether there is one form of justice for ordinary citizens and a fundamentally different form of justice for company managers and directors.

Directors need to carry personal responsibility for good corporate governance. A GSB could develop a register of directors of companies that transgress good governance practice. A 'three strikes and you're out' system could be evolved.

Many will vehemently protest the idea of holding directors personally responsible. However, UK law already has provisions for disqualifying individuals from holding directorships under certain circumstances (eg. personal bankruptcy, unfit conduct, wrongful trading, etc.). The question, therefore, is not whether individuals should ever be disqualified from holding directorships – that principle is already well-established. Rather the question is under what circumstances that should or should not happen.

In that context, what are the arguments to support a view that that individuals who consistently show themselves unable to practice good governance should reasonably be allowed to keep holding director positions in major companies? Could this not reasonably count as 'unfit conduct'?

Imposing penalties on companies rather than directors is both morally and technically suspect

- *a GSB should maintain a register of directors of companies that do not fulfil their corporate governance responsibilities*
- *any individual who appears on the register three times should be disqualified from holding a company directorship for a period of not less than five years*

This approach has an additional benefit. It will encourage companies to build varied Boards that include individuals who are able and willing to challenge what might become embedded groupthink. For instance, the suggestion of having workers' representatives on UK unitary Boards generated a frenzy of almost hysterical proportions. Yet Boards may well choose for themselves to include someone who can bring the workers' viewpoint to the table if they felt that that would inject a different perspective that could avoid falling foul of the GSB with the personal consequences that that would entail for all directors.

In an article describing ongoing research with the INSEAD business school, Ron Soonieus put it like this *"It is surprising how seldom these subjects [creating sustainable and viable business models around innovation, investments, environmental responsibility, etc] appear spontaneously on the agenda of the board. If they do, it is usually driven by the executive board, mostly the CEO. And if long-term value creation gets discussed in the board, we find it's often the board member nominated by the Works Council who puts the subject on the table."* [12]

Of all stakeholders, employees are the ones with the greatest interest in the long term sustained success of a company

This is hardly surprising since, of all stakeholders, it is a company's employees that have the greatest interest in the long-term, sustained success of a company.

Having diverse boards that can bring different and even contrarian perspectives to bear is likely to be a crucial element in improving governance. However, apart from requiring workers' representative on boards, diversity of ideas on a board is not something that can be mandated by government. What government can do is to create a regulatory framework that is demanding enough for it to be clear to management that a diverse board is essential if companies are to keep within the regulatory framework. Combined with holding directors personally accountable, and therefore boards risking resignations if the corporate governance framework is not adhered to, this approach has a reasonable chance of success.

4. REFORMING COMPANY LAW

HOW CAN THE WAY IN WHICH THE INTERESTS OF EMPLOYEES, CUSTOMERS AND WIDER STAKEHOLDERS ARE TAKEN INTO ACCOUNT AT BOARD LEVEL IN LARGE UK COMPANIES BE STRENGTHENED?

Question 7, page 14 of government's green paper

The green paper states that *"UK company law already enshrines the importance of wider interested groups in corporate governance."* However, it is also worth being explicit (which the green paper is not) about the fact that UK company law is very clear that shareholders hold a privileged position relative to other stakeholders. The law clearly states that directors' primary duty is to shareholders while 'having regard' to the interests of other stakeholders.

The green paper gives the impression that this is not up for discussion. The wording suggests that the current company law framework is up to the job. The green paper goes on to frame the challenge as being limited to finding ways *"to ensure that all companies are taking the steps needed to understand and take account of wider interests and different social perspectives."* (p 34).

The government's commitment to maintaining shareholders' privileged position is further reinforced in the green paper section on executive compensation where much of the faith for controlling the excesses of executive pay seems to be placed in shareholder control. Executive pay is addressed in more detail in the next section and mentioned here only in the context of shareholders' privileged statutory position.

The approach of privileging shareholders over other stakeholders is fundamentally flawed. Company directors can never be expected to take proper account of all stakeholders when they are required by law to privilege one group of stakeholders over all others.

> Shareholder value thinking doesn't work – not even for shareholders

The idea of reducing the value of a corporation to 'shareholder value' and then measure that through stock prices can be traced back to Milton Friedman – the economist whose ideas will go down in history as probably having wreaked the greatest damage to societies far and wide. Yet the idea became consensus in the 1980s. *"Today this consensus is crumbling... Shareholder primacy theory is suffering a crisis of confidence. This is happening in large part because it is becoming clear that shareholder value thinking doesn't seem to work, even for most shareholders."* [7]

The rationale and evidence for this are compelling. Given the fundamental importance of this point, a paper by Lynn Stout summarizing the arguments in her book *"The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public"* is attached as an Appendix to this paper.

THE INEVITABLE CONCLUSION:

- *company law should be modified to provide more even rights for all stakeholders under the law.*

This would be part of Zadek's previously quoted call for a move *"away from intensive [ie. single minded focus on a single stakeholder] towards an extensive [ie. a focus on all stakeholders] accountability.* (Author's brackets).

This conclusion has much support from many in the business world. Jack Welch, legendary former CEO of GE, called the idea of maximizing shareholder value "the dumbest idea in the world." [13] Xavier Huillard, Chairman and CEO of the Vinci Group called it "totally idiotic", Jack Ma, CEO of Alibaba, Paul Polman, CEO of Unilever, Jack Mackey at Whole Foods, Jeff Bezos of Amazon, Mark Benioff CEO of Salesforce, and others, have all railed against the notion of maximizing shareholder value as the primary purpose of business. [14]

> "Maximising shareholder value is the dumbest idea in the world."
>
> Jack Welch

4.1 WHY BUILD A STAKEHOLDER ECONOMY?

Britain and the US have been leaders in constructing shareholder economies – economies where investors (shareholders) have rights that trump those of any other stakeholder. In discussions with leaders of publicly owned businesses and industry associations, there is a clear reluctance to consider any change to this position. The most common response is "that model has served us well." But further probing often fails to elicit any evidence on how 'it has served us well' or who the 'us' is that it has served well. There are some compelling reasons why broadening of directors' responsibilities must be approached with care. These are discussed in Section 4.2. Here the paper focuses on the advantages and disadvantages of shareholder versus stakeholder economies.

It is intuitively believable that, because it is a shareholder economy, Britain has managed to attract a significant amount of investment – though that, of course, depends on very many factors. It has the largest financial market in Europe and the most developed financial services industry. These may all be, in part, consequences of the shareholder economy. But two points are worth making here:

1. *there is a difference between the interests of financial intermediaries (as represented by the financial services industry, including asset managers) and the interests of the ultimate holders of those assets (the shareholders). The two are often not aligned*
2. *will the UK's shareholder economy remain attractive once it becomes more widely accepted that a shareholder economy doesn't benefit anyone – not even shareholders? (In this context it might be as well to distinguish 'shareholders' (ie. those who have some interest in the companies of which they hold stock) from stock traders (short-term speculators).*

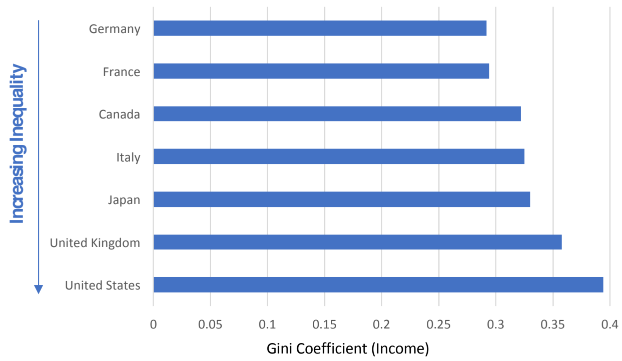
And what of the other downsides?

INCREASED INEQUALITY

It seems obvious that, in a shareholder economy, more wealth will be accumulated by investors than by any other group. Maybe because of this, the UK and the US have the highest levels of both income and wealth inequality among the G7 countries. This has been made worse by the Bank of England's prolonged Quantitative Easing programme.[15]

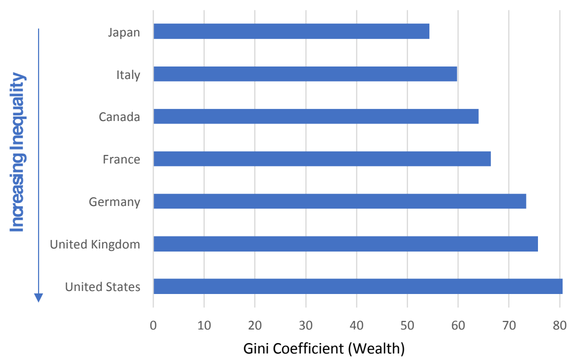
The UK and US show the highest levels of income and wealth inequality

Income Inequality



Source: OECD, 2011-2014

Wealth Inequality



Source: Allianz Global Wealth Report 2015

One can therefore reasonably question whether the government's stated aims of building an economy that works for everyone can be achieved while the statutory requirement of privileging shareholders above all else remains in place. And one can further question whether the government is serious about achieving this aim if the whole precept of a shareholder economy is not up for discussion.

The Gini Coefficient is the most widely recognized measure of inequality. If the government wishes to create an economy that works for all, it should consider a Gini Policy: a target Gini Coefficient that it will aim to hit over a defined time-period. That would concentrate the mind somewhat more than simply the odd political sound-bite that can be conveniently forgotten.

> It is doubtful that the government can build an economy that works for everyone while shareholders maintain a privileged position relative to all other stakeholders

- *the government should consider setting a Gini Policy: a Gini coefficient that it will aim to achieve over a defined time-period*

A FINANCIALIZED ECONOMY

Shareholder economies inevitably become increasingly financialized. This means that all value that is exchanged becomes reduced to a financial instrument that can be traded. Or, as Greta Krippner of the University of Michigan puts it, a *"pattern of accumulation in which profit making occurs increasingly through financial channels rather than through trade and commodity production."* Trading of financial instruments then becomes a money-making activity in and of itself with the underlying value that was created in the real economy largely becoming irrelevant.

Over time, it inevitably directs companies – and particularly those where senior executive compensation is tied to stock price performance – to prioritise stock price performance over investment in the patient growth of their business whenever the two are in conflict.

This is one reason for the continued weakening of the real economy in the UK. When one talks about the UK economy being unbalanced, this is not only limited to geographical disparities and a dependence on the financial services industry that some consider excessive. As a shareholder economy, the UK has prioritized stock market performance over other considerations including job creation, the building of resilient industries that have a long-term focus and, in fact, an economy that works for everyone not just the privileged few.

Finally, it also needs to be borne in mind that investors are also prioritized by the UK tax system. Dividends and capital gains are subject to lower rates of taxation than income. The tax system therefore also prioritises gains from investment over gains from work.

In such a system that systematically favours investment over employment, it should come as no surprise that owners of capital will progressively become ever wealthier relative to those who depend on earned income (ie. most people). This in not to suggest in any way that we should move away from an economy driven by private investment to a state-controlled economy – as some continue to suggest. However, we also need to recognize that an economy that is systematically biased in favour of returns to capital rather than being at the very least neutral between returns to investment and returns to employment will consistently drive towards greater inequality. While such a systematic bias is maintained, any reforms that purport to aim to reduce inequality risk being no more than tokenism.

> The UK economy is systematically structured to reward investment over employment

> Growing inequality is embedded in such a system

Reducing or eliminating such systematic bias is a far better way to tackle inequality than the only other alternative – ever-increasing money transfers from the wealthy to the less wealthy using the tax system.

At a broader level, there is also the less immediately obvious but potentially more corrosive issue of how economies such as that of the UK and the US are perceived to value the dignity of work – and the risky political implications of such choices.

Harvard's Michael J Sandel in an article titled *Lessons from the Populist Revolt* puts it like this:

> *"The loss of jobs to technology and outsourcing has coincided with a sense that society accords less respect to working-class occupations. As economic activity has shifted from making things to managing money, with hedge fund managers and Wall Street bankers receiving outsize rewards, the esteem accorded to work in the traditional sense has become fragile and uncertain."* [16]

The fundamental question for Britain is whether there is a belief that the future of the UK economy lies in managing money rather than making things (or providing non-financial services). And whether the major attraction for Britain as a place for business investment is a system that remains systematically skewed in favour of investors relative to other stakeholders. If that is believed to be the case, it doesn't say much for the quality of British business management. Neither does it render credible any move towards an economy that works for everyone.

IS SHAREHOLDER VALUE TRULY CREATED VALUE?

As Umair Haque puts it in The New Capitalist Manifesto, *"shareholder value isn't a reliable measure of whether authentic economic value has been created. It is value that can be transferred from other stakeholders rather than created anew."* [17]

> Environmental damage is one way of transferring wealth from the many to the few

An example of this is environmental damage - one of the elements that company law states that company directors should have regard for in their decision making. Industrial practices that damage or destroy the environment without appropriate payment for such damage, are a means by which communally owned property ('the commons') is converted into private wealth that, in a financialized shareholder economy, largely accumulates at the top and to financial intermediaries. It is another form of transfer of wealth from the many to the few. At least a proportion of the shareholder value thus created is not, in fact, created at all. It is value taken from some stakeholders and transferred to others. This and many other examples represent what Haque calls 'thin value' and economist Jack Hirshleifer calls 'socially useless' value.

Neither can company directors be blamed for such behaviour. They are only doing what they are required to do by statute – putting the interests of shareholders above all else. No company is about to offer to internalise voluntarily all its externalities as that would negatively affect the amount of value transferred to shareholders.

> *"Impact investors and social entrepreneurs are constrained by current law that makes it difficult to know when they are allowed to consider additional interests, such as public benefit. Due to this legal uncertainty, directors still fear civil claims if they depart from their fiduciary duties to maximize profit."* [18]

Finally, which shareholders are directors supposed to be privileging? Those that hold stock for many years or those that hold stock for a fraction of a second? We will come back to this point in the context of executive compensation. But, in law, both have equivalent rights and directors are playing with fire if they choose to privilege one at the expense of the other.

MAKING DIRECTORS' LIVES IMPOSSIBLE

The debate about whether all stakeholders should have more even status under the law is not a new one. It raged a decade ago when company law was last reviewed and changed. At that time, one argument was that company directors should have one main obligation under the law rather than being required to balance the needs of multiple stakeholders. This argument barely stacks up. Company directors, like the rest of us, have to make trade-offs and balance multiple interests all the time. Besides, it stretches credibility to assume that capable, highly paid UK company directors don't have the skills and capabilities to balance the interests of multiple stakeholders as, for instance, directors in stakeholder economies seem to be able to do. If that were true, we have bigger problems that we might think.

The government's green paper is explicit in its recognition that, in a number of companies, there is insufficient regard being given to other stakeholders – one purpose of the proposed reforms. However, director risk being put in an impossible position if new corporate governance reforms create tougher rules for protection of all stakeholders while they are still bound by a statutory responsibility to privilege shareholders. It is perfectly reasonable for business leaders to resist being put in such a position.

> Corporate governance standards and company law risk pulling company directors in opposite directions

Further, giving directors responsibilities towards all stakeholders provides them with much greater flexibility as to how they might choose to manage their business. This has the potential to unleash broad experimentation as different Boards choose the balance they feel is most appropriate for the long-term interests of their business without fear of being challenged by some investors that their interests were not being privileged. Investors would still have choice as to which companies they choose to invest in.

FEAR OF TAKEOVER

Of course, there is little point in working hard to create a stakeholder economy if companies that build such businesses are then subject to takeover by companies that have a different philosophy and may be based offshore where UK governance standards may not apply. Decades of work might be undone in a matter of months.

Though this does not directly affect corporate governance reform, it is a factor that both business and the government need to consider. It also highlights previous comments that corporate governance cannot be considered in isolation. It needs to be evaluated within the context of the whole ecosystem within which UK business operates.

The current Secretary of State has indicated that he is in favour of some kind of public interest test in evaluating foreign takeovers – a suggestion also put forward during the coalition government but not progressed at that time. Should such an initiative go forward, corporate governance standards might be one component to be considered as part of the debate.

In the UK, regulation applies to all UK listed companies whether they are registered in the UK or not. But it does not apply to companies that have no UK listing.

- *corporate governance standards could be part of any future public interest test applied to foreign takeovers*

SHORT-TERMISM

We come back to the issue of short-termism. Even with the best will in the world – and regulatory intervention – a shareholder economy will always tend towards a shorter-term focus as company directors end up being driven by the demands of asset managers (note: not shareholders) to beat short-term earnings targets and consistently out-perform arbitrary benchmarks. This is highly damaging to the economy.

A 2005 US survey of 401 financial executives by Duke University's John Graham and Campbell R. Harvey, and University of Washington's Shivaram Rajgopal, reveals that companies manage earnings with more than just accounting gimmicks: A startling 80% of respondents said they would decrease value-creating spending on research and development, advertising, maintenance, and hiring in order to meet short-term earnings benchmarks. More than half the executives would delay a new project even if it entailed sacrificing value. [19]

Many will protest that short-termism is not inevitable in a shareholder economy. Even if one were to accept that short-termism is not inevitable, all empirical evidence shows that that is the way it is in practice. But short-termism is, actually, inevitable. Because *"the financial system operates on a set of norms which equate all human values with financial value, where value is the market price"* [20] (in this case the stock price). Short-termism is therefore embedded in the DNA of a financialized shareholder economy. And no amount of good intention – or, for that matter, regulation – can possibly change that.

> Short-termism is embedded in the DNA of a shareholder economy

WHERE WILL DEMAND COME FROM?

It is not clear whether the story is apocryphal. When, in the 1950s, a US union leader was taken on a tour of a newly automated Ford Motor plant, he was asked by a company manager: *"Aren't you worried about how you're going to collect union dues from all these machines?"* The union leader's reply: *"The thought that occurred to me was how are you going to sell cars to these machines?"*

This raises the important question that forms the title of a report by researchers at the Universities of Greenwich and Warwick for the International Labour Office (ILO): Is aggregate demand wage-led or profit-led?[21] A shareholder economy implicitly assumes that demand is profit-led. This may seem intuitively reasonable when looking at the issue globally. Multi-national corporations can lower labour costs by pushing down wages and/or shifting labour to the cheapest countries (increasing wealth and demand in those countries), optimize their taxes and, through increasing profits, return more money to shareholders. Then, one hopes, completing the virtuous cycle of further business investment, more jobs, etc. This has been the neo-liberal economic consensus since the 1980s.

But within country (and the UK government's primary responsibility is to the local economy), one can see how progressive relative wage decline eventually ends up stifling demand and leading to a stagnating economy.

In fact, it seems that things are not quite so clear-cut. The ILO researchers conclude:

> *"At the national level, a decrease in the wage share leads to lower growth in the euro area, Germany, France, Italy, UK, US, Japan, Turkey, and Korea, i.e. these economies are wage-led, whereas it stimulates growth in Canada, Australia, Argentina, Mexico, China, India, and South Africa; thus the latter group of countries are profit-led. However, a simultaneous decline in the wage share in all these countries leads to a decline in global growth. Furthermore, Canada, Argentina, Mexico, and India also contract when they decrease their wage-share along with their trading partners. Thus the global economy in aggregate is wage-led."*

This is yet another illustration of the long-term damage caused by a shareholder economy – including, in the longer-term, to shareholders. And especially those investing in companies that have limited international demand for their products or services.

4.2 MITIGATING THE RISKS

There are some real risks associated with moving towards a stakeholder economy.

The main one is that narrow interest groups (environmental activists, employee representatives, etc.) may take the view that their particular, narrow interests are not being given sufficient weight in Board decision making. This has the potential to unleash endless complaints or even civil suits by interest groups that only care about their own interests rather than the balance of interests that a Board has to deal with.

This is a real issue. It can be mitigated through the actions of the previously suggested Governance Standards Body:

- *companies should be required to submit an annual review of their activities (including how they have balanced different stakeholder interests) to the GSB (much like Premium Listed companies are already required to do)*
- *companies whose reports have been reviewed and approved by the GSB (with appropriate verification) should be shielded from legal liability*
- *interest groups that have particular perspectives of any company's performance can submit their evidence to the GSB and request a review*

> Companies must be protected against disruptive actions by single-issue activist groups

Unfortunately, activist groups do not do themselves any favours by their obsessive single-issue focus and a seemingly willful blindness to the fact that most decisions involve difficult balancing acts between varied and often conflicting interests. It is important that companies have some degree of protection against such behaviours.

- *individuals or groups submitting review requests to the GSB should be banned from submitting further reviews for a period of five years if they have previously submitted three reviews and all of them have been fully rejected*

4.3 REPORTING

The green paper outlines the requirement for Premium Listed companies to report their adherence to the governance code separately from their financial reporting. This should be retained as suggested above. The question is whether, in the absence of common standards and with the high degree of discretion open to boards in how they produce such reports, such reporting consistently provides a reliable reflection of how businesses are actually being managed. We have all learnt through bitter experience that even financial reporting to accounting standards painstakingly developed over long periods can be a poor guide to the financial health of a business. The value of relying exclusively on free-form reporting that is largely up to a board's discretion can reasonably be challenged. Therefore, in addition,

- *businesses should be required to provide Integrated Reporting or Impact Reporting (also known as six capital reporting) on at least an annual basis*
- *such reports should be subject to external verification*

The business benefits of going beyond simple financial reporting have been described by Group 100, an association of Australia's senior finance executives, as follows:

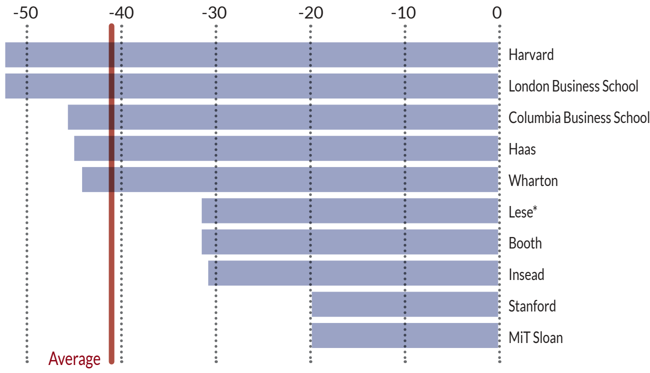
> *"Alignment of company reporting with the expectations of key stakeholders serves to improve the quality of a company's relationship with such stakeholders and thus protect and enhance the value of the organization."* [22]

There are other practical reasons to move in this direction – not least the recruitment and retention of talent. Surveys have shown that the millennial generation place social responsibility much higher than previous generations when they evaluate companies they will seek out for employment. And they are much more willing to change jobs if they feel that their employing organisation does not have a sense of purpose and social responsibility.

The investment banking community is already suffering in this regard from the reputational damage of the financial crisis (Figure).

MBAs turn away from investment banking

Change in popularity of investment banking between 2008 and 2014



Figures are % of full-time MBA graduates taking new jobs in investment banking, sales and trading and brokerage unless otherwise stated *Figures are banking, not investment banking. Source FT research.

Advocates of Integrated Reporting put forward the following benefits:

- *a system that builds on what is available rather than inventing it anew*
- *forward looking rather than backward looking*
- *improved financial stability and sustainable development*
- *more effective resource allocation*
- *better aligned to long-term goals of business and society and reduction of incentives for short-term thinking*
- *better and more transparent information for investors allowing better investment decisions*

To avoid external entities that verify such reports being captured by the interests of the corporations they are verifying (as has happened with both accounting audits and with credit rating agencies)

- *external entities verifying the non-financial aspects of integrated reporting should be different to those entities auditing companies' financial reports*
- *such entities should not be allowed to have any other business with the companies whose reports they are verifying*
- *companies should be required to change external verifying entities at least every three years*

WHO SHOULD REPORT?

WHICH TYPE OF COMPANY DO YOU THINK SHOULD BE THE FOCUS FOR ANY STEPS TO STRENGTHEN THE STAKEHOLDER VOICE? SHOULD THERE BE AN EMPLOYEE NUMBER OR SIZE THRESHOLD?

Question 8, page 14 of government's green paper

The green paper raises the issue of how far beyond Premium Listed companies to extend any broader reporting requirements. In our view, there is no reason why privately held companies or large partnerships should be held to any different standards than publicly held ones. Good governance should extend to the whole of corporate Britain (large partnerships in effect operate as corporations).

The more relevant question is whether there should be a minimum size below which such reporting should not be required so as not to create unreasonable burdens for smaller businesses and kill the emergence of challengers to large incumbents.

The positive social effects that businesses have on communities seems to be size dependent. In 2012, the journal Economic Development Quarterly showed this:

> *"Economic growth models that control for other relevant factors reveal a positive relationship between density of locally owned firms and per capita income growth, but only for small (10-99 employees) firms, whereas the density of large (more than 500 workers) firms not owned locally has a negative effect."* [23]

- *Integrated Reporting should cover all firms with more than 500 workers, including firms that effectively employ 500 people but avoid listing them as employees*

WHAT TO REPORT?

The suggestion is to use Integrated Reporting [24] as the appropriate metric. An alternative is to use triple bottom line (TBL) reporting. The use of Integrated Reporting has several advantages:

- *it looks at return on six 'capitals': financial, manufactured, human, social & relationship, intellectual and natural and is therefore more comprehensive than TBL reporting*
- *the methodology is well developed and can be immediately implemented.*

While the overall aims and approaches of Integrated Reporting and Impact Reporting are well established, some will argue that the specific metrics to be used are not yet standardized. Standardised metrics do not go much beyond limited aspects such as carbon reporting. While this is true, it is no reason not to start implementing these reporting systems. Once companies are required to report in this way, metrics will develop and be tried out. Trial and error will allow the emergence of best practice from which standardized metrics can then be evolved. This bottom-up, evolutionary approach is preferable to the bureaucratic approach of setting up some global standards body that will take twenty years or longer to agree standards by which time our economies and our environment will be well and truly unrecoverable. Calls for the bureaucratic approach should be seen as nothing more than obstructionism.

> The UK has chosen to give up its early leadership in corporate responsibility

It should be noted that the UK was the pioneer in extending reporting beyond the financial. Anita Roddick (now Dame Anita Roddick) introduced the concept of corporate responsibility beyond shareholder returns and implemented the world's first triple bottom line, externally audited report, the Body Shop's 'Values Report' in February 1996.

The UK has chosen to give up its leadership in this field with other countries now being more advanced.

4.4 NEW CORPORATE FORMS

Benefit Corporations or B-Corps are US designed entities that *"meet the highest standards of verified social and environmental performance, public transparency, and legal accountability, and aspire to use the power of markets to solve social and environmental problems."* They are a growing phenomenon and have well developed and documented standards of behaviour, measurement and audit that go to the triple bottom line/ six capitals concept. US public benefit corporations include Patagonia, Ben & Jerry's, Seventh Generation and Warby Parker.

Certified B-Corps are starting to spread to Europe. They are, however, not yet a recognised corporate form in company law except in Italy which established the *Societá Benefit* on the US model.

Setting up B-Corps as a new corporate form is one example of bottom-up regulation. It creates the circumstances where companies can freely choose a corporate form that allows them to distinguish themselves from compeitiors because of their mission driven governance. It is not clear why there should be any objections to providing companies with choice by enshrining B-Corporations in company law in the UK. This would allow both private and public corporations a free choice to operate under that form.

WE SUGGEST THAT:

- *B-Corporations should be enshrined in company law in a form that allows both publicly owned and privately owned companies to choose to operate under that form*

Such a legal form also makes it easier to unleash larger amounts of investment from impact investors and social entrepreneurs. It would also remove the previously mentioned legal uncertainty for both investors and company directors.

The UK has a rapidly growing sector of impact investors and socially responsible investors. The introduction of B-corporations could unleash significant growth in these sectors.

TAX ADVANTAGES?

It would also be reasonable to argue that, seeing as B-Corporations are measurably and verifiably adding more social and environmental value than their counterparts, they should be subject to lower rates of corporate tax since they are already making contributions that reduce the public expenditure that would otherwise be required for corrective action.

That was the author's original view. However, it was challenged. The argument went that if B-Corps were given tax advantages, they would draw in a number of corporations simply to benefit from the tax advantages rather than because of management's commitment to the model. In other words, such a move would contaminate the B-Corp universe with the profit maximising mindset and end up with a number of B-Corps whose management was focused on benefiting from the tax breaks while doing their best to circumvent the intent. In doing so, it would forego the opportunity truly to stimulate bottom-up cultural change.

The arguments are finely balanced. The charge of contaminating B-Corps with the profit maximising mentality and thereby reducing their effectiveness is a very powerful one. Set against that is the possibility that a tax advantage would lead to faster penetration of the concept within the corporate world. If the metrics for compliance with B-Corp status are sufficiently rigorous and effectively enforced, then the opportunities to game the system are reduced but, of course, never fully eliminated.

All in all, providing tax breaks is not the primary aim. Whether this ends up being a good idea or not can only be judged within the overall framework that the government establishes for improving corporate governance. For further discussion.

DO WE NEED IT?

Some will argue that the UK already has enshrined in law community interest companies in their various forms and that makes B-corporations unnecessary. That is not the case.

Community interest companies have social benefit as their primary purpose. B-corporations do not. They are simply companies that are profit-making entities but that verifiably hold themselves to higher standards of corporate governance in a verifiable way.

5. EXECUTIVE COMPENSATION

There is nothing inherently wrong with high levels of executive compensation.

Issues arise when such executive compensation is widely seen as either excessive, or undeserved, or widely out of line with the compensation levels of the whole employee pool of the company concerned. Or when compensation structures are so flawed that they drive behaviours that are economically and socially damaging. It could well be argued that all these negative conditions currently apply.

From a pure financial viewpoint, it is reasonable to take the view that executive compensation is receiving much more attention than it deserves. Whatever a few senior executives get paid in large companies has very little direct financial impact on corporate profits or shareholder returns. However, as we shall see, the damage to the overall economy is probably not inconsiderable.

> Executive compensation is seen primarily as a political not a financial or business issue

Having said that, executive compensation is seen primarily a political issue not a business issue. For instance, rightly or wrongly, the high salaries received by others (eg. footballers) have not raised the same level of outrage as executive salaries. It is not high salaries per se that are at issue but the broader political and economic context.

As the green paper states: *"Executive pay is an area of significant public concern, with surveys consistently showing it to be a key factor in public dissatisfaction with large businesses."*

Recognising executive compensation for how it is currently seen – a primarily political rather than business issue – is important if one is to work towards a viable solution. Political and business perspectives come together in the joint desire to maintain a positive political environment in which big business can operate in the UK. Whether this degree of commonality is sufficient to have all sides working in the same direction remains to be seen.

5.1 WHY HIGH COMPENSATION?

> *"It is right that our major companies should be able to attract and retain top management talent, recognising that many of the leaders of our most successful companies are recruited from outside the UK."*

So states the green paper.

It goes on to say: *"It is difficult to assert with confidence the link between executive pay and long-term company performance at individual companies."*

These statements suggest two possible justifications for high pay: international competition and as a driver of performance. Neither of them stacks up, as it happens.

PAY AND PERFORMANCE

The accepted consensus from all research done on the subject both in Europe and the US shows that there is no convincing correlation across the board between high pay and company performance – with some researchers positing a negative correlation. True, aggregated results do not necessarily tell us about individual companies – and there may always be outliers. But this is sophistry.

The green paper quotes a report from the Executive Remuneration Working Group that fails to find a direct link between executive pay and business performance. This is something that most of us have intuitively understood – especially following the financial crisis of 2008 when some of the most highly paid executives were at the helm of companies that brought much of the global economy to its knees – and were then bailed out using ordinary taxpayers' money – yet more transfers from the poor to the wealthy.

A more recent study of 701 companies from the Vlerick Business School's Executive Remuneration Centre [25] found, among other things, that:

- *across Europe, better performing companies do not pay their chief executives more. Pay differences are a function of company size not company performance.*

A 2005 paper from Harvard and Cornell examined growth in executive pay between 1993 and 2003. It concluded: *"During this period pay has grown much beyond the increase in firm size, performance and industry classification. Had the relationship of compensation to size, performance and industry classification remained the same in 2003 as in 1993, mean compensation in 2003 would have been only about half its actual size."* [26]

Executive compensation is seen primarily as a political not a financial or business issue

In a collection of essays for the High Pay Centre, Alexander Pepper from the London School of Economics said that studies since 1990 had either failed to demonstrate a positive link between executive pay and corporate performance or, at best, the link was very weak. [27]

So it would seem that performance is not a primary driver of high pay awards.

INTERNATIONAL COMPETITION

This leaves international competition for talent as the justification for high levels of remuneration.

But this is a market mechanism that inevitably leads to ever-higher ratcheting of compensation levels.

Every time companies make high pay awards to attract talent, they ratchet upwards the average level of compensation leading to yet higher pay levels, and so on. *"Everyone wants to be in the top quartile"* according to the previously quoted Mr Melvin. [6]

This upward ratcheting was laid bare in the recent shareholder objections to a proposed increase in remuneration for Alice Cooper, CEO of Imperial Brands. David Haines, chair of the company's remuneration committee, was quoted as saying that pay rises were needed – not just for Cooper but other executives – because pay was *"significantly below the average for companies of our size"*. [28] No mention of performance.

This inevitable ratchet effect combined with the fact that the impact of high remuneration levels is political rather than financial, suggests that direct government intervention is the only viable route towards tackling the issue.

International competition for talent does not stack up as support for executive pay levels

In addition, the above quoted study from Vlerick also showed:

- *total remuneration for chief executives of the biggest UK companies by market value was almost 50% higher than chief executives of similarly sized German companies (the next most highly paid in Europe) and almost one and a half times earnings at Sweden's biggest companies*

Unless one starts to claim that the UK can only survive and prosper by recruiting mainly from the highest paid ranks of corporate America, then the international competition argument is also shaky.

Having said all that, the politics of executive compensation are complicated by the fact that many on the government benches abhor, for ideological reasons, any kind of intervention, even in cases of obvious market failure. This, combined with resistance from big business and political donors, make it unclear as to whether any kind of effective reform is possible or whether the government will be pushed back to making cosmetic changes that allow it to claim that something has been done while, in practice, achieving little

PRIDE AND SOCIAL CACHET

It is as well to be explicit that much of the drive for high compensation levels is one of personal pride and social cachet among senior executives. Many are wealthy enough that the money is not of particular relevance. However, there is the perceived need to keep up with the Joneses. Some senior executives feel under-appreciated if their packages are lower than those they consider their peers. High compensation levels (especially if supposedly tied to performance) are also worn as a badge of honour – evidence of the quality of their management that can be brandished when looking to move into higher positions.

These are real human factors that cannot be ignored in a bunch of economic statistics. They are significant drivers of high compensation packages as well as of the ever-higher ratcheting of such packages. The answer lies in changing social norms and what constitutes social cachet. This is a long-term process. But it can be done.

Executive pay is more about human psychology and social norms than it is about numbers and complex technical analyses

However, it also highlights the fact that remuneration committees cannot successfully address these issues by taking a mechanistic approach to compensation packages. These are matters of human psychology and human feelings as much, if not more, than they are matters of economics. It is one of the many areas where modern, technocratic managerialism falls down.

The author was involved in a company where different methods of compensation were explored. The eventual system adopted focused on psychological factors and cultural norms within the company rather than technical analyses.

Business unit leaders were given clear financial targets and expected behavioural norms to be observed.

Once those were clear, leaders were totally free to award themselves and their staff whatever compensation packages they wished with absolutely no limitations and no requirement for any kind of uniformity across business units. They were, however, required to share details of all compensation packages (including their own) with staff and explain how the judgements had been made.

Besides making superfluous the tedious annual process of adversarial salary and bonus negotiation (and also requiring much less human resources professionals – and no expensive consultants), over time, the net result of this system was higher pay for lower level employees and lower pay to higher level executives compared to peer companies.

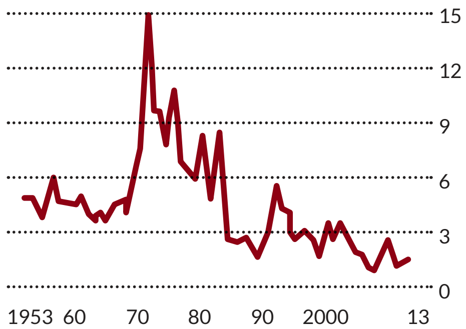
5.2 TYING COMPENSATION TO STOCK PRICES – MORE HARM THAN GOOD

Senior executives argue that tying compensation to stock price, a relatively recent fad, has, in fact, ensured that compensation levels reflect company performance. Not so. And for more than one reason.

The first is that, in a financialized economy, stock price performance becomes increasingly dissociated from underlying company performance – and especially from long-term value creation.

Second, a singular focus on stock price performance inevitably drives behaviours that may not be in the best interests of building sustainable companies. Share buybacks become a more attractive use of capital than investing in business growth (Figure); setting companies up to be acquired by foreign firms may become more attractive than growing the business; and so forth.

The ratio of cash spent on investment vs distributed to shareholders continues to fall



Source: Andrew Smithers

It should be remembered that until 1982 large stock buybacks were illegal in the US because they constituted obvious stock price manipulation. The Reagan administration swept this away unleashing what *The Economist* called a resort to "corporate cocaine." [29]

That it is a focus on stock price performance that drives such behaviours is clear from a 2014 study by economists from the Stern School of Business and Harvard Business School. They found that, keeping company size and industry constant, private U.S. companies invest nearly twice as much (6.8%) as publicly listed companies (3.7 %).[30]

Finally, many compensation packages dissociate metrics that determine compensation levels from long-term value creation almost by design:

> *"In the 1990s, for example, many companies introduced stock options as a major component of executive compensation. The idea was to align the interests of management with those of shareholders. But the generous distribution of options largely failed to motivate value-friendly behavior because their design almost guaranteed that they would produce the opposite result. To start with, relatively short vesting periods, combined with a belief that short-term earnings fuel stock prices, encouraged executives to manage earnings, exercise their options early, and cash out opportunistically. The common practice of accelerating the vesting date for a CEO's options at retirement added yet another incentive to focus on short-term performance."*[10]

A CFA UK Executive Remuneration Report published in December 2016 concludes:

> *"Simplistic metrics of short-term performance such as earnings per share (EPS) growth and total shareholder return (TSR) are the dominant means of measuring performance in CEO remuneration contracts. Worryingly, these metrics correlate poorly with theoretically more robust measures of value creation that relate performance to the cost of capital."* [31]

Of course, attempts have been made to moderate some of these perverse consequences through regulation – such as delaying vesting periods. But that has so far been insufficient.

5.3 WHY NOTHING HAS WORKED

The issue of high levels of executive compensation has been a running sore for some time. Much has been tried but nothing has worked. The debate has been characterized by being full of sound and fury, signifying nothing.

There are many reasons why nothing has worked.

> In executive compensation, much has been tried but nothing has worked

As outlined above, is that it is very difficult to regulate executive remuneration effectively. Companies have found it easy to circumvent the intent of regulation by adjusting the structure of remuneration packages.

The second is that, as the green paper points out, methods for calculating compensation packages are often anything but transparent. This further makes it difficult to regulate.

And, as also outlined above, technocratic pseudo-rational approaches trump psychological and human factors in most of today's corporations – with often disastrous results.

THE RESULT:

> *"Despite relentless pressure from regulators and governance reformers over the last two decades to ensure closer alignment between executive pay and performance, the association between CEO pay and fundamental value creation in the UK remains weak."* [21]

However, the greatest issue – both from a compensation and from a macroeconomic perspective – is by far the false religion of shareholder value maximization and the tying of executive compensation to poor, short-term measures of stock price performance. Until this is addressed directly, all else will remain largely an exercise in futility.

SHAREHOLDER POWER DOES NOT PROVIDE THE ANSWER

The green paper comes across as putting quite a bit of faith in shareholders as one of the main routes (if not the only route) to exercising control over executive compensation. It asks whether shareholder power should be increased when determining executive remuneration packages and, if so, how.

Some investor groups have already exercised considerable pressure on corporate compensation packages. In general, this has not been a sufficient corrective – at least in terms of public opinion. It is, of course, unknowable whether, absent behind the scenes discussions between shareholder groups and management, pay awards would have been even higher than they are today. This paper argues that this is highly unlikely to change simply by giving investor groups more formal powers – and for several reasons.

Shareholders in any individual company are not a homogeneous group that act in concert. Rather they are disparate and fragmented; each individual and each institution having their own set of perspectives and objectives. As such, it is unlikely that there will be concerted action by investors that is sufficient to bring about real change in executive compensation. Further, most ultimate owners of stock do not have a direct say – they are represented by financial intermediaries whose interests may be quite different.

> Putting one's faith exclusively in investor groups to control executive pay is the equivalent of doing little or nothing

Some institutional investors have shown particular interest in the long-term success of the companies in which they hold stock. They believe that corporate governance is an important factor in long-term value creation and have pressured companies accordingly.

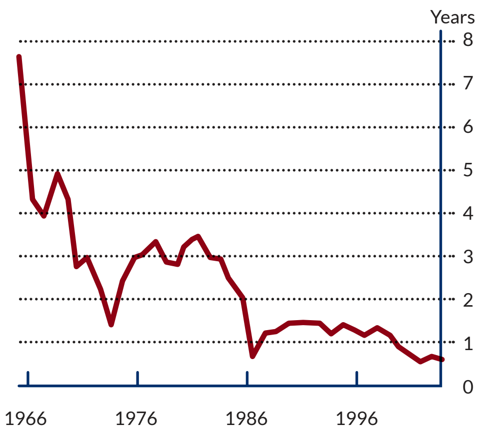
However, for other investors, issues like executive compensation are seen as minor in that, as we have outlined above, they do not have an immediate impact on profits. Some may also feel that high compensation is a price worth paying for a chief executive with a hard-nosed focus on short-term stock price performance rather than one who spends too much time considering other stakeholders' interests. Other investors do not take much interest at all in any of these issues. They are passive investors who happen to hold some stock. For the short-term traders, all this is of little if any relevance since their interests are determined by day-to-day market fluctuations rather than anything at all to do with how a company is run.

For all investors, including the interested institutional investor, there is always a balance to be struck between the task of taking on management practices or simply dis-investing and moving on. Except that, in the case of the largest corporations, some institutional investors' ability to disinvest is somewhat limited by the fact that they may be required to hold stock in those companies that make up the main stock market indices. That only affects a small proportion of the business world – albeit also the group most likely to have the highest levels of executive pay.

The reality is that, even for the interested investor, executive compensation is only one of very many considerations that have to be considered when investing in any company. For a significant proportion – maybe even the vast majority – of investors, executive compensation is probably well down the list of factors that need to be balanced.

Finally, it is more than just a stretch to believe that investors can guide the long-term governance of corporations when the average holding period for stocks has declined dramatically to six months or less (Figure). If one wished to take it to extremes, some have reported that high frequency trading has taken the average holding period down to 22 seconds in the US. [32]

With the average holding period for stocks declining precipitously to less than six months, it is not credible to rely on shareholders to impose a long-term view



Source: London Stock Exchange

If our analysis has any truth at all, for the government to place all its faith in investors to moderate executive compensation is equivalent to doing very little.

That is not to say that investors should not be encouraged and maybe even empowered to act. It's simply that, like much of what has gone before, on its own, it's all very unlikely to work.

- *investors cannot be the only, or maybe even the main, route to moderating executive compensation.*

5.4 RELATIVE PAY CONTINUES TO DIVERGE

Question 4 on page 13 of the green paper starts: *"Should a new pay ratio reporting requirement be introduced?"*

The issues with pay ratios have been well discussed and will not be repeated here. Publishing pay ratios will not achieve very much except a lot of vituperative column inches.

However, the above question underlines the fact that it is not simply the level of executive pay that is at issue but rather executive pay in relation to pay for other employees in the same company.

> Senior executive compensation is determined on a different basis to other employees

The main reason why pay differentials continue to widen is that, in many companies, senior executive compensation is determined on a totally different basis to the compensation of regular employees. Senior executive rewards are often linked in some way to stock price performance or, in unlisted firms, to the business performance of the firm. In some companies, employees at all levels have some parts of their remuneration tied to firm performance. But this is usually minimal when compared to executive packages. In yet other firms, employee compensation is largely seen as a cost that needs to be kept as low as possible if the firm is to prosper.

This situation can be caricatured as follows: low employee pay translates into higher short-term earnings and better short-term stock price performance which, in turn, translates to higher executive pay packages. Of course, this is a caricature of a much more complex situation. Yet it is not without some grains of reality: what is considered to be a firm's 'success' pushes executive and employee compensation in opposite directions.

Support for the caricature comes from a combination of sources:

- *an analysis from the TUC based on OECD data showed that the UK was at the bottom of the heap – matched only by Greece – in the decline in real wages since the pre-crisis peak. In both countries wages declined by around 10.4% over the period.* [33] *(One should also point out, which the study does not, that this fall in wages was offset by maintaining relatively high levels of employment even during the post-crisis period – maybe a reasonable trade-off)*
- *a report by the High Pay Centre in August 2016 showed that in the previous year alone, CEO pay for FTSE 100 companies rose by 10% to an average of £5.5 million* [34]
- *a letter from 16 trade associations to the Secretary of State for Business, Energy and Industrial Strategy urged the government to slow down the plans for a rise in the living wage* [35]

The combination of these three data points makes it difficult to ascertain whether British business is doing well and therefore can reasonably increase executive compensation. Or whether it is doing badly and therefore needs to exercise downward pressure on wages. Our theory provides a reasonable framework within which these data points can be interpreted.

5.5 BUT WHAT TO DO ABOUT IT?

This situation is difficult to resolve and, in fact, has not been resolved through any of the methods that have been tried. Of course, individual firms exist that operate to a different philosophy. But such firms do not yet make up the majority of businesses. If they did, the whole conversation would be obsolete.

One could increase the vesting period for options (see below), the time-period for which stock has to be held, and extend the claw-back period for bonus payments – as has already been attempted. Or one could insist that compensation packages be based on a broader range of performance measures. But it's impractical to expect government to get into the executive compensation design business. And simplicity and transparency are probably to be valued more than complexity and spurious accuracy.

However, a GSB would have executive compensation as one of its metrics for evaluating governance quality:

- *a GSB could develop the skills to evaluate the reasonableness of different compensation package design and work with industry towards an accepted best practice*

But, this assumes that there is such a thing as a compensation package that is clearly 'reasonable'. And, as discussed, the issue is not just executive compensation but executive compensation in the context of remuneration levels across the rest of the company. It is these misaligned incentives that one needs to get at if one is to have any kind of effect. Can one work towards a situation where incentives are aligned across the whole company?

- *one option is to ban tying executive compensation to short-term stock price performance.*

The current system has been shown not to result in any relationship between pay and performance. Also, in a stakeholder economy, it makes little sense to tie compensation to a single metric that does not reflect either firms' long-term prospects or stakeholder interests.

Mr Colin Melvin of Hermes EOS suggests something similar: significant simplification and aligning compensation with long-term company performance:

- *"Pay executives in cash and shares that they have to retain for a long period, certainly beyond their departure from the company. That's it. No bonus. No need for consultants, no need for performance targets, which might be irrelevant in a year or so"*[6]

It is difficult to argue against the principles embodied in this suggestion. Some will argue that performance-related components are essential. There is no evidence for such a statement. In fact, any evidence there is points in exactly the opposite direction.

What constitutes good performance in a large corporation is so complex and variable over time that trying to reduce it all to a few metrics doesn't work (as we have seen).

Performance related financial incentives reduce performance and encourage unethical behaviour

Additionally, all the mounting evidence shows that performance-related financial incentives do not improve performance – they actually drive it down while also increasing unethical behavior. For instance, it has been shown that in eight out of nine tasks examined, higher incentives led to worse performance.

A group of scholars from the Harvard Business School, Northwestern University's Kellogg School of Management, the University of Arizona's Eller College of Management, and the University of Pennsylvania's Wharton School concluded that setting rewards for performance goals for those in jobs that are complex and multi-faceted (like senior executives) *"cause systematic problems for organizations due to narrowed focus, unethical behavior, increased risk taking, decreased cooperation, and decreased intrinsic motivation."* [36] We have all seen these behaviours and the consequences of many of them have been documented in this paper.

Yet, in the face of all the evidence, business seems unable to shake off the culture of goal-related pay - where, as we have seen, the measured goals rewarded end up being very different to the performance desired for the long-term success of both corporations and the economy.

> *"On both sides of the Atlantic, the gap between what science is learning and what business is doing is wide."* [37]

AS A RESULT:

- *having a large component of compensation related to inevitably flawed performance metrics should be heavily discouraged*

It is in this context that one can see how the previous UK government's resistance to capping bankers' bonuses was utterly wrong-headed.

An alternative option is to focus more explicitly on aligning incentives within the company:

- *companies could be required to apply the same compensation principles at all levels of employment*

How on earth would *that* work?

Of course, it is reasonable that compensation levels differ at different levels of the company. However, the intention is to ensure that compensation levels tend to move in sync rather than diverge over time.

The way this would work is that every company can determine for itself the principles on which compensation will be determined. However, whatever the method chosen it has to be applied uniformly across the firm – albeit at different levels of compensation. This would ensure that if executive packages increase, so would employee pay – and vice versa.

Besides aligning incentives across the whole firm, this approach would ensure greater transparency – another objective put forward in the green paper. If compensation packages were to be uniform across a firm, complex and unintelligible pay frameworks would not work. They would have to be relatively simple and transparent.

OPTIONS VS STOCK

The UK tax system favours the award of stock options over the award of stock. This has a good intellectual rationale (options can be considered valueless at the time of award whereas stock is not). However it also introduces complexity. Options are much more difficult to value, notwithstanding Black-Scholes models and other methods that attempt to put a value on something that is largely impossible to value – no matter the efforts to disguise that undeniable fact in unintelligible mathematics. The result is that nobody can tell what compensation levels are when issued in options.

Options also tend to have short vesting periods, tend to vest on change of control, or vesting is accelerated when executives leave the company – even when they leave because of poor performance. All incentives that work against the long-term interests of the firm.

If the UK decides to maintain its tax preference for options over stock, then opacity of the real value of compensation packages needs to be accepted. However, the situation can be improved if:

- *vesting periods for stock options are set at a minimum of five years*
- *accelerated vesting is banned*
- *change of control results in the issue of options in the new entity (with the vesting period starting from scratch) rather than vesting*

Some will argue that five years is too short a time frame. That may be right in the context of the long-term interests of the firm and its stakeholders. But this needs to be balanced against setting time frames that would be unreasonably long given the age of some of the executives involved. At the risk of added complexity, vesting periods could be related to the age of the executives with younger executives having longer vesting periods.

Many corporations are already moving in these directions – albeit not at lightning speed.

BAN LARGE SCALE STOCK BUYBACKS

Finally, because of the perverse incentives that they induce, the macroeconomic damage that they do, and the fact that they represent self-serving stock price manipulation:

- *large scale stock buy backs should be discouraged or banned – just as they were in the US prior to 1982*

An alternative is to allow large scale stock buybacks only for those companies whose senior executives have no part of their compensation tied to stock price performance. That would allow companies choice while avoiding what can be considered nothing short of self-dealing.

6. MAPPING A WAY FORWARD

> *"What collapsed on September 15, 2008, was not just a bank or a financial system. What fell apart that day was an entire political philosophy and economic system, a way of thinking about and living in the world."* [38]

We are in the midst of significant cultural and political change. Old assumptions and previous ways of doing things are falling away. Culturally we see a move away from the narrow focus on money accumulation to a broader understanding of the various components that go to making a good life. At a recent meeting, a 23-year-old entrepreneur who had just started his third company stood up and declared: *"I don't know how many people there are here from the corporate world. But I have to tell you that my generation doesn't want to work for you any more. We want innovative environments, a good work-life balance and work that has meaning beyond just making money."*

The familiar assumptions on which economics has been based since the 1980s are now widely accepted to have fundamental flaws that are causing widespread damage to our economies.

> We are in the midst of significant cultural and political change

Politically, a so-called 'populist' revolution is upending all previous assumptions. Nationalism is back and globalization has become a dirty word. A new US President is arm-twisting multinational corporations to repatriate jobs. Rising inequality has mobilized a whole political movement that is intent on kicking big business hard where it hurts. Civil society organisations scrutinize corporations' every move and can mobilize protest and resistance that can have significant negative effects on profits.

Business leaders cannot absolve themselves of all responsibility for the growth of these movements and the emergence of new and successful political forces which have now come back to bite them. Brexit was a result of many things, among them disillusionment with a business world that seemed to be enveloped in its own concerns without much time to ponder on the corrosive effects of emerging business practice and the damaging impact of some of the most egregious behaviours. Now Britain is headed out of the European Union with as yet unknown consequences for British business.

> Structures set by government have enabled destructive behaviours

But blame cannot be laid exclusively at the foot of big business. The environment in which business operates and the incentives set by consecutive governments through the regulatory framework have at the very least enabled, at worst driven, the very behaviours that have proven to be destructive in the long term.

6.1 THE GOVERNMENT SHOULD BE MORE AMBITIOUS

It is in this context that the proposed corporate governance reforms must be judged. It is no longer a question of the odd little adjustment here and the next little cosmetic tweak there. Rather it's a question of how to shape a political economy that fits the zeitgeist. A political economy that can move beyond the destructive elements of the populist revolt once more to create a positive atmosphere that allows us to build the sort of society that we would all like to live in.

In that context, the green paper is both encouraging and a disappointment.

> The government's green paper lacks ambition

It is encouraging that the government recognizes that reform of corporate governance is an important component of creating a more balanced economy. It is disappointing in that the green paper suggests a lack of ambition to take on the fundamental structural factors that are necessary if it is to achieve its stated aims.

6.2 ACHIEVING CHANGE AT SCALE

We can all observe businesses and business leaders that are at the cutting edge of a different way of thinking and doing. Leaders that are showing what business can and should be – a force that looks well beyond the narrow focus of transferring value from broader society to shareholders to the much wider landscape of business as a positive social force. A force that has a big influence on the shape of the political economy and has an important role to play in maintaining social cohesion and caring for communally owned property such as the environment.

> The public hears all about bad corporate practice but rarely about the good

Sadly, these initiatives make less strident headlines than do corporate scandals. The public is therefore bombarded with examples of the bad and barely ever hears about the good.

Such high-quality businesses have always existed and there are maybe more of them today than there ever have been. The challenge is not to let such businesses remain isolated "islands of integrity" but to use what these businesses can teach us to achieve change at scale.

Doing so will require addressing the root causes – the cultural and structural factors that enable and drive certain behaviours. It also requires an ability on all sides of the debate to break out of conventional group-think. To challenge long-held beliefs that have become part of the tribal furniture and are no longer questioned. One of the aims of this paper is to be provocative enough maybe to start the process of challenging conventional wisdom.

6.3 GOVERNMENT AND MARKETS: A PARTNERSHIP

Corporate governance operates at the intersection of politics and commerce – a space that has always been an uncomfortable place to be. One can only hope that both business leaders and policy makers have now got over the long-outdated 1980s consensus that government and markets operate either separately or in opposition. Both are essential, intimately intertwined, and need to operate in partnership.

"The emerging worldview of Capitalism 4.0 will need to recognize that the world is too complex and uncertain to be understood, let alone managed, by a naive reliance on markets, as in the last version of capitalism, or by excessive faith in benign and omniscient government, as in the model before. In Capitalism 4.0, experts who claim to divine the future according to immutable economic laws are likely to be dismissed as charlatans, because the one thing we will know for certain about economics and public policy is that nothing is certain"19

That is why this paper calls for a consensus based process towards evolving a better corporate governance framework. It is why it calls for an acceptance that nobody can possibly get it right first time and that a clear process of regular review and constant evolution is essential.

The success of the effort will depend on two factors. The first is whether the government has sufficient ambition and determination to want to live by its own words – to create an economy that works for everyone not just the privileged few. The second is whether business recognizes that the world is changing, has changed, dramatically and irreversibly. That dragging of heels, obstructionism and seeking to maintain the status quo are no longer either wise or viable options.

Neither is the argument that business is already moving in the right direction and needs no further pushing in any way convincing. Progress is far too slow and far too patchy.

> Markets will lead us where we want to be only if government sets the right structures

Markets only operate within a set of structures, incentives and institutions. They are capable of unleashing a tremendous amount of energy within those frameworks. But if the frameworks are either wrong or outdated, then the energy and creativity unleashed will lead us to places we do not want to be. It is government's job to set those structures, incentives and institutions – and to keep improving them. Then markets can do the rest.

That is why this paper is clear in its stance that the issues we face are not market problems. They are problems resulting from outdated structures, incentives and institutions. It is there that efforts must start to adjust the UK economy on to a new path.

The author urges the government to be more ambitious in what it is hoping to achieve and urges business leaders, investors, trade unions and all others for whom corporate governance is of interest to engage constructively in a robust but collaborative discussion to explore potential ways forward.

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The Shareholder Value Myth

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The Shareholder Value Myth

By Lynn A. Stout

Shareholder primacy theory is suffering a crisis of confidence. In *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public* Lynn Stout discusses how the traditional managerial focus on the shareholder's interest can be harmful for the corporation and even for shareholders themselves and how it is more valuable to spread the focus over several objectives**.**

Shareholder Value and its Disappointments

By the end of the 20th century, a broad consensus had emerged in the Anglo-American business world that corporations should be governed according to the philosophy often called shareholder primacy. Shareholder primacy theory taught that corporations were owned by their shareholders; that directors and executives should do what the company's owners/shareholders wanted them to do; and that what shareholders generally wanted managers to do was to maximize "shareholder value," measured by share price.

Today this consensus is crumbling. As just one example, in the past year no fewer than three prominent New York Times columnists have published articles questioning shareholder value thinking.[1] Shareholder primacy theory is suffering a crisis of confidence. This is happening in large part because it is becoming clear that *shareholder value thinking doesn't seem to work, even for most shareholders*.

"Shareholders are suffering their worst investment returns since the Great Depression; the population of publicly-listed companies has declined by 40%."

Consider the example of the United States. The idea that corporations should be managed to maximize shareholder value has led over the past two decades to dramatic shifts in U.S. corporate law and practice. Executive compensation rules, governance practices, and federal securities laws, have all been "reformed" to give shareholders more influence over boards and to make managers more attentive to share price.[2] The results are disappointing at best. Shareholders are suffering their worst investment returns since the Great Depression;[3] the population of publicly-listed companies has declined by 40%;[4] and the life expectancy of Fortune 500 firms has plunged from 75 years in the early 20th century to only 15 years today.[5]

Correlation does not prove causation, of course. But in my book *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public*,[6] I explore the logical connections between the rise of shareholder value thinking and subsequent declines in investor returns, numbers of public companies, and corporate life expectancy. I also show that shareholder primacy is an abstract economic theory that lacks support from history, law, or the empirical evidence. In fact, the idea of a single shareholder value is intellectually incoherent. No wonder the shift to shareholder value thinking doesn't seem to be turning out well — especially for shareholders.

Debunking the Shareholder Value Myth: History

Although many contemporary business experts take shareholder primacy as a given, the rise of shareholder primacy as dominant business philosophy is a relatively recent phenomenon. For most of the twentieth century, large public companies followed a philosophy called managerial capitalism. Boards of directors in managerial companies operated largely as self-selecting and autonomous decision-making bodies, with dispersed shareholders playing a passive role. What's more, directors viewed themselves not as shareholders' servants, but as trustees for great institutions that should serve not only shareholders but other corporate stakeholders as well, including customers, creditors, employees, and the community. Equity investors were treated as an important corporate constituency, but not the only constituency that mattered. Nor was share price assumed to be the best proxy for corporate performance.[7]

Go back further, to the very beginnings of business corporations, and we see even greater deviations from shareholder primacy. Many corporations formed in the late eighteenth and early nineteenth centuries were created specifically to develop large commercial ventures like roads, canals, railroads, and banks. Investors in these early corporations were usually also customers. They structured their companies to make sure the business would provide good service at a reasonable price – not to maximize investment returns.[8]

So where did the idea that corporations exist only to maximize shareholder value come from? Originally, it seems, from free-market economists. In 1970, Nobel Prize winner Milton Friedman published a famous essay in the New York Times arguing that the only proper goal of business was to maximize profits for the company's owners, whom Friedman assumed (incorrectly, we shall see) to be the company's shareholders.[9] Even more influential was a 1976 article by Michael Jensen and William Meckling titled the "Theory of the Firm."[10] This article, still the most frequently cited in the business literature,[11] repeated Friedman's mistake by assuming that shareholders owned corporations and were corporation's residual claimants. From this assumption, Jensen and Meckling argued that a key problem in corporations was getting wayward directors and executives to focus on maximizing the wealth of the corporations' shareholders.

Jensen and Meckling's approach was eagerly embraced by a rising generation of scholars eager to bring the "science" of economics to the messy business of corporate law and practice. Shareholder primacy theory led many to conclude that managerialism must be inefficient and outmoded, and that corporations needed to be "reformed" from the outside. (There is great irony here: free-market economist Friedrich Hayak would have warned against such academic attempts at economic central planning.)[12] Shareholder primacy rhetoric also appealed to powerful interest groups. These included activist corporate raiders; institutional investors; and eventually, CEOs whose pay was tied to stock price performance. As a result, shareholder primacy rose from arcane academic theory in the 1970s to dominant business practice today.[13]

"Traditionally, shareholders' governance rights in public companies are limited and indirect, including primarily their right to vote on who sits on the board, and their right to bring lawsuits for breach of fiduciary duty."

Debunking the Shareholder Value Myth: Law
Yet it is important to note that shareholder primacy theory was first advanced by economists, not lawyers. This may explain why the idea that corporations should be managed to maximize shareholder value is based on factually mistaken claims about the law.

Consider first Friedman's erroneous belief that shareholders "own" corporations. Although laymen sometimes have difficulty understanding the point, corporations are *legal entities that own themselves*, just as human entities own themselves. What shareholders own are shares, a type of contact between the shareholder and the legal entity that gives shareholders limited legal rights. In this regard, shareholders stand on equal footing with the corporation's bondholders, suppliers, and employees, all of whom also enter contracts with the firm that give them limited legal rights.[14]

A more sophisticated but equally mistaken claim is the residual claimants argument. According to this argument, shareholders are legally entitled to all corporate profits after the fixed contractual claims of creditors, employees, suppliers, etc., have been paid. If true, this would imply that maximizing the value of the shareholders' residual interest in the company is the same thing as maximizing the value of the company itself, which usually benefits society. But the residual claimants argument is also legally erroneous. Shareholders are residual claimants only when failed companies are being liquidated in bankruptcy. The law applies different rules to healthy companies, where the legal entity is *its own* residual claimant, meaning the entity is entitled to keep its profits and to use them as its board of directors sees fit. The board may choose to distribute some profits as dividends to shareholders. But it can also choose instead to raise employee salaries; invest in marketing or research and development; or make charitable contributions.[15]

Which leads to the third legal error underlying shareholder primacy: the common but misleading claim that directors and executives are shareholders' "agents." At law, a fundamental characteristic of any principal/agent relationship is the principal's right to control the agent's behavior. But shareholders lack the legal authority to control directors or executives. Traditionally, shareholders' governance rights in public companies are limited and indirect, including primarily their right to vote on who sits on the board, and their right to bring lawsuits for breach of fiduciary duty. As a practical matter, neither gives shareholders much leverage. Even today it remains very difficult for dispersed shareholders in a public corporation to remove an incumbent board.[16] And shareholders are only likely to recover damages from directors in lawsuits involving breach of the duty of loyalty, meaning the directors were essentially stealing from the firm. Provided directors don't use their corporate powers to enrich themselves, a key legal doctrine called the "business judgment rule" otherwise protects them from liability.[17]

The business judgment rule ensures that, contrary to popular belief, the managers of public companies have no enforceable legal duty to maximize shareholder value.[18] Certainly they can choose to maximize profits; but they can also choose to pursue any other objective that is not unlawful, including taking care of employees and suppliers, pleasing customers, benefiting the community and the broader society, and preserving and protecting the corporate entity itself. Shareholder primacy is a managerial choice – not a legal requirement.

Debunking the Shareholder Value Myth: Evidence

Which leads to the question of the empirical evidence. As noted above, the law does not require corporate managers to maximize shareholder value. But this certainly is something managers can opt to do. And certain corporate governance strategies — putting more independent directors on boards, tying executive pay to share price, removing "staggered" board structures that make it harder to oust sitting directors — are widely recognized as effective means to make managers embrace raising share price as their primary objective. If shareholder primacy theory is correct, corporations that adopt such strategies should do better and produce higher investor returns than corporations that don't. Does the evidence confirm this?

Surprisingly, the answer to this question is "no." Researchers have spent decades and produced scores of studies seeking to prove that shareholder primacy generates superior business results. Yet there is a notable lack of replicated studies finding this.[19] For example, one survey looked at more than a dozen studies of supposedly shareholder-hostile companies that used dual-class share structures to disenfranchise public investors. Some studies found dual-class structures had no effect on corporate performance; some found a mild negative effect; and some studies found a positive effect (in one case, a strongly positive effect), exactly the opposite of what shareholder primacy theory predicts.[20]

But more important, studies that examine whether supposedly shareholder value-maximizing strategies improve the performance of an individual company for a year or two are looking in the wrong place and at the wrong time period. Individual shareholders may perhaps care only about their own investing returns in the near future. But policymakers and governance experts should care about public equity returns to investors as a class, over longer periods. As already noted, if we look at returns to public equity investors as a class, over time, the shift to shareholder primacy as a business philosophy has been accompanied by dismal results.

Why? The answer may lie in recognizing that shareholder value-increasing strategies that are profitable for one shareholder in one period of time can be bad news for shareholders collectively over a longer period of time. The dynamic is much the same as that presented by fishing with dynamite. In the short term, the fisherman who switches from using baited lines to using dynamite sees an increase in the size of his catch. But when many fishermen in the village begin using dynamite, after an initial increase, the collective catch may diminish steadily. Shareholders may experience the same regrettable result when they push managers to "maximize shareholder value."

"Shareholder value-increasing strategies that are profitable for one shareholder in one period of time can be bad news for shareholders collectively over a longer period of time."

There Is No Single Shareholder Value

To understand why shareholder primacy can be compared to fishing with dynamite, it is useful to start by recognizing an awkward reality: there is no single "shareholder value." Shareholder primacy looks at the world from the perspective of a Platonic shareholder who only cares about one company's share price, at one moment in time. Yet no such Platonic entity exists.

"Shareholders" actually are human beings who happen to own shares, and human beings have different interests and different values. Some shareholders plan to hold long-term, to save for retirement; others are speculators, eager to reap a quick profit and sell. Some shareholders want companies to make long-term commitments that earn the loyalty of customers, employees and suppliers; others may want to profit from opportunistically exploiting stakeholders' commitments. Some investors are undiversified (think of the hedge fund manager whose human and financial capital are both tied up in the fate of one or two securities). Most are diversified, and worry about the performance of multiple companies as well as their own health, employment prospects, and tax burdens. Finally, some shareholders may not care if their companies earn profits by breaking the law, hurting employees and consumers, or damaging the environment. But others are "prosocial," willing to sacrifice at least some investment returns to ensure the companies they invest in contribute to, rather than harming, society.

It is these divisions between shareholders' interests that allow some shareholders to profit by pushing companies to adopt strategies that harm other shareholders. The divisions make it possible for shareholders to "invest with dynamite," as it were.

Investing With Dynamite

As an example, consider the conflict between short-term and long-term investors. It was once believed (at least by academic economists) that the market price of a company's stock perfectly captured the best estimate of its long-term value. Today this idea of a perfectly "efficient" stock market has been discredited, and it is widely recognized that some business strategies can raise share price temporarily while possibly harming the company's long-term prospects. Examples include cutting expenses for marketing or research and development; siphoning off cash that might otherwise be invested for the future through massive dividends or share repurchase plans; taking on risky leverage; and selling off all or part of the company. Hedge funds and other activist investors are famous for pushing boards to adopt such strategies. (Consider Carl Icahn's recent efforts to get Transocean to pay out dividends rather than reducing its debt.)[21] This is profitable for the activists, who typically sell immediately after the share price rises. But over time, this kind of activism diminishes the size and health of the overall population of public companies, leaving investors as a class with fewer good investing options.

A similar dynamic exists when it comes to how companies treat stakeholders like employees and customers. Shareholders as a class want companies to be able to treat their stakeholders well, because this encourages employee and customer loyalty ("specific investment").[22] Yet individual shareholders can profit from pushing boards to exploit committed stakeholders — say, by threatening to outsource jobs unless employees agree to lower wages, or refusing to support products customers have come to rely on unless they buy expensive new products as well. In the long run, such corporate opportunism makes it difficult for companies to attract employee and customer loyalty in the first place. Some investors profit, but again, the size of the total investing "catch" declines.

"Shareholders as a class want companies to be able to treat their stakeholders well, because this encourages employee and customer loyalty ("specific investment")."

Conflicts of interest between diversified and undiversified shareholders raise similar problems. For several years, BP paid large dividends and kept its share price high by cutting safety corners to keep expenses down. Undiversified investors who owned only BP common stock benefited, especially those lucky enough to sell before the Deepwater Horizon disaster. But when tragedy finally struck, the BP oil spill damaged not only of the price of BP shares, but also BP bonds, other oil companies operating in the Gulf, and the Gulf tourism and fishing industries. Diversified investors with interests in these other ventures would have preferred that BP focused a bit less on maximizing shareholder value. Similarly, consider the irony of a pension fund portfolio manager whose job is to invest on behalf of employees pushing companies to raise share prices – by firing employees. This harms not only investors who are also employees, but all investors, as rising unemployment hurts consumer demand and eventually corporate profits.

Finally, consider the differing interests of asocial investors who do not care if companies earn profits from illegal or socially harmful behaviors, and prosocial investors who don't want the companies they invest in to harm others or violate the law. The first group wants managers to "unlock shareholder value" at any cost, without regard to any damage done to other people or to the environment. The second group does not. Asocial investing – one might even call it sociopathic investing[23] – may not harm corporate profits in the long run. Thus it presents a different problem from other shareholder value strategies, discussed above, that reduce long-run investing returns. But it presents ethical, moral, and economic efficiency problems of its own.

Which Shareholders and Whose Values?

Closer inspection thus reveals the idea of a single "shareholder value" to be a fiction. Different shareholders have different values. Many, and probably most, have concerns far beyond what happens to the share price of a single company in the next year or two.

Some shareholder primacy advocates might nevertheless argue that we need to embrace share price as the sole corporate objective, because if we judge corporate performance more subjectively or use more than one criterion, managers become unaccountable. This argument has at least two flaws. First, we routinely judge the success of endeavors by multiple, often subjective, criteria. (Even eating lunch in a restaurant requires balancing cost against taste against calories against nutrition.) Second, the philosophy of "maximize shareholder value" asks managers to focus only on the share price of their own company, in the relatively near term. In other words, it resolves conflicts among shareholders by privileging the small subset of shareholders who are most shortsighted, opportunistic, undiversified, and indifferent to ethics or others' welfare — the lowest common human (perhaps subhuman) denominator. This seems a high price to pay for the convenience of having a single metric against which to measure managerial performance.

There may be a better alternative: replace corporate maximizing with corporate "satisficing."

The Satisficing Alternative

Milton Friedman and other late twentieth-century academic economists were obsessed with optimizing: picking a single objective, then figuring out how to maximize it. This preference for analyzing problems from an optimizing perspective may reflect a taste for reductionism. It may also reflect a taste for mathematics. (Although math can help you figure out how to maximize a single variable, it is much less useful for telling you how to pick and choose among several.)

But optimization is rarely the best strategy for either organisms or institutions. For example, if biology favored optimizing a single objective, humans would not need to drag around the weight of an extra kidney. And if people made decisions by optimizing, we would not find ourselves debating between taste, calories, and nutrition in choosing what to eat for lunch. Similarly, Nobel Prize winning economist Herman Simon argued more than a half-century ago that corporations need not try to optimize a single objective. Rather, firms can pursue several objectives, and try to do decently well (or at least sufficiently well) at each rather than maximizing only one. Simon called this "satisficing," a word that combines "satisfy" with "suffice."[24]

"Firms can pursue several objectives, and try to do decently well (or at least sufficiently well) at each rather than maximizing only one."

"The disappointing results of shareholder primacy suggest the satisficing approach may be better not only for shareholders, but for the rest of us as well."

Satisficing has many advantages as a corporate decision-making strategy. Most obviously, it does not try to resolve conflicts among different shareholders by maximizing only the interests of the small subset who are most short-term, opportunistic, undiversified, and asocial. It allows managers instead to try to decently (but not perfectly) serve the interests of many different shareholders – including long-term shareholders; shareholders who want the company to be able to keep commitments to customers and employees; diversified shareholders who want to avoid damaging their other interests as investors, employees, and consumers; and prosocial shareholders who want the company to earn profits in a socially and environmentally responsible fashion.

When managers are allowed to satisfice, they can retain earnings to invest in safety procedures, marketing, and research and development that contribute to future growth. They can eschew leverage that threatens the firm's stability. They can keep commitments that build customer and employee loyalty. They can protect their shareholders' interests as employees, taxpayers and consumers by declining to outsource jobs, lobby for tax loopholes, or produce dangerous products. Finally, they can respect the desires of their prosocial shareholders by trying to run the firm in a socially and environmentally responsible fashion.

Of course, if managers don't also earn profits, they won't be able to do these things for long. But the satisficing approach recognizes that while earning profits is necessary for the firm's long-term survival, it is not the *only* corporate objective. Once profitability is achieved, the firm can focus on satisfying other goals, including future growth, controlling risk, and taking care of its investors, employees, customers, even society. Our recent experience with the disappointing results of shareholder primacy suggest this approach may be better not only for shareholders, but for the rest of us as well.

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no legal obligation to maximize either profits or share value.
19. About the only empirical finding that has been reliably replicated is that when governance changes cause directors to sell a company, the buyer pays a premium over market price. This increases the wealth of shareholders in target companies. Unfortunately, it also often depresses the stock prices of bidding companies by an equal or greater amount, suggesting that mergers and acquisitions do not increase the wealth of shareholders as a class. One study has concluded that the net result for all shareholders of all mergers and acquisitions done between 1980 and 2001 was to reduce aggregate market value by $78 billion. See Stout, supra note 6, at 88-89.
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