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Corporate Governance, Stakeholders, and Corporate Social Responsibility

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An overview

- Corporate Governance, Stakeholders, and CSR Responsibility
- Gatekeepers & Corporate Scandals
- Technology

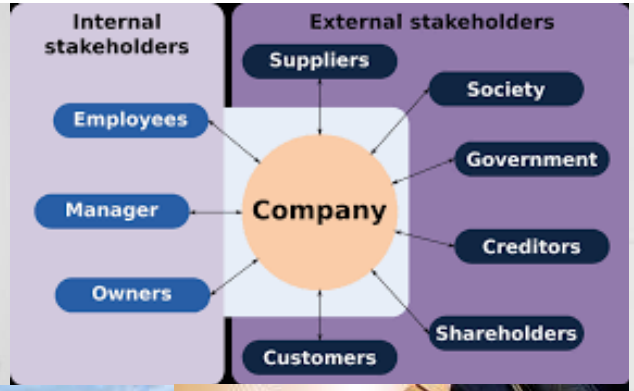
Issues at stake

- Are shareholders owners? What do they own?
- Companies are a different type of property – evolution from company representing collective personality of shareholders late 18th/early 19th century to separate legal personality
- ‘Companies affect the destinies of employees, communities, suppliers, and customers.’
- Should we moralize the company?

Key words

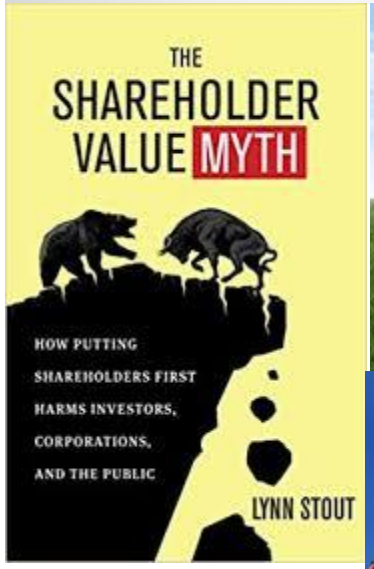
- Shareholders and Stakeholders
- Shareholder Value and Stakeholder Value
- Long term and Short term
- Drivers of corporate governance
- Principle-Agent Problem
- Fiduciary Duties
- Corporate Social Responsibility
- Institutional Investors, Hedge Funds, Index Funds
- Environmental Social Governance (ESG) indicators


Shareholder
Roles
Decide on any organizational decision
Checking and making approvals of the financial statements.
Discuss, decide & vote for directors of company.
Decide on the directors' salary.
WallStreetMojo

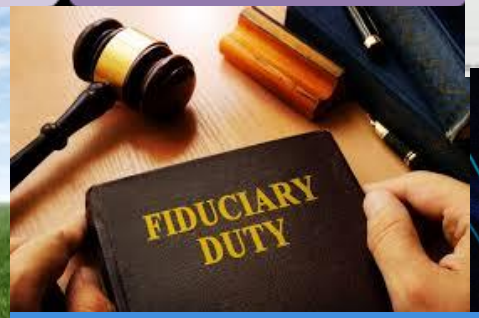

Internal stakeholders
External stakeholders
Suppliers
Society
Employees
Government
Manager
Company
Creditors
Owners
Shareholders
Customers


CORPORATE SOCIAL RESPONSIBILITY


E
S
G

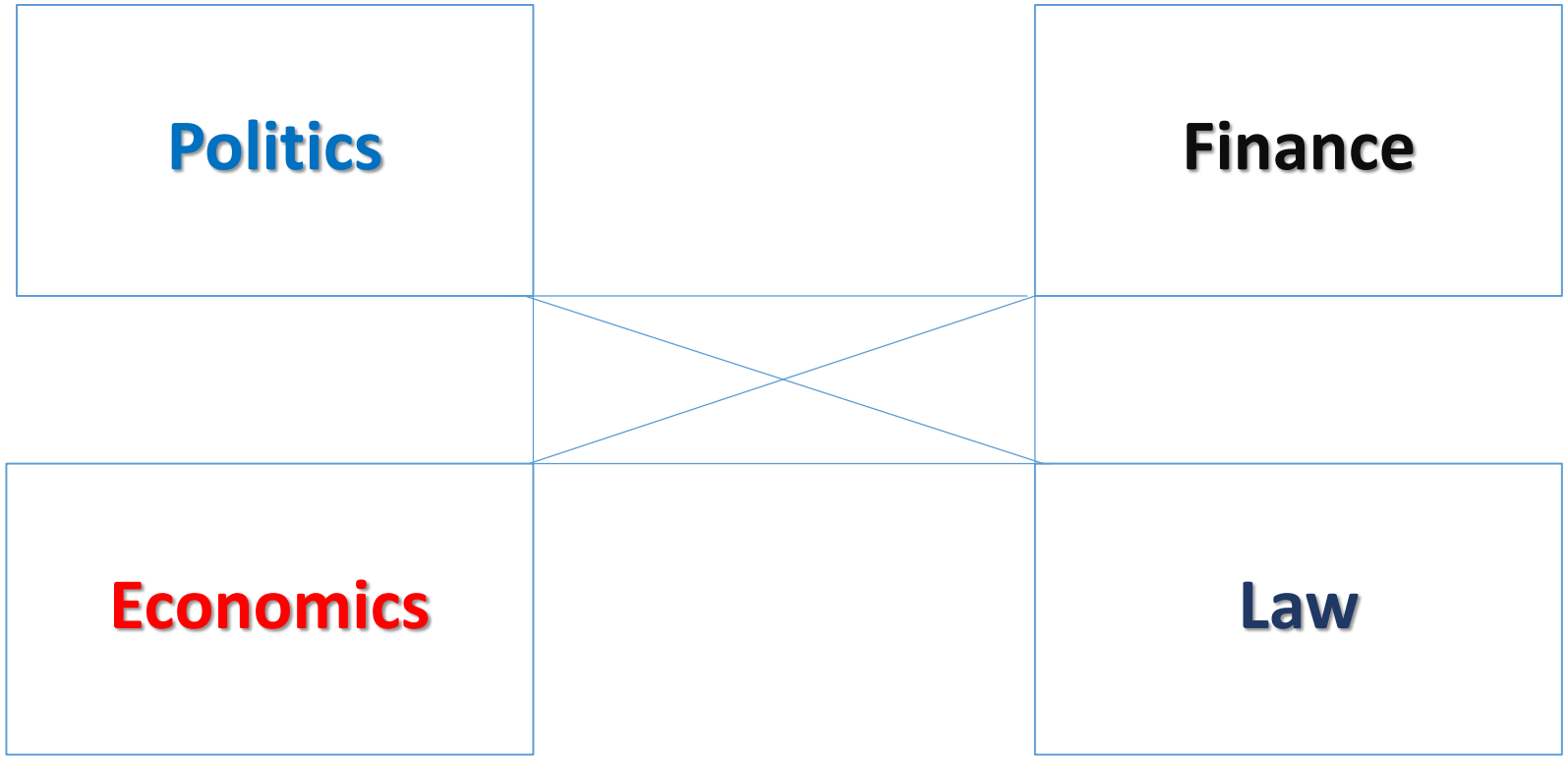

THE SHAREHOLDER VALUE MYTH
HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC
LYNN STOUT


LONG TERM
SHORT TERM


FIDUCIARY DUTY


BLACKROCK
Vanguard

The drivers of Corporate Governance



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The Roadmap

Universal Corporation

Sustainability & Stakeholderism

Shareholder Value

The Corporate Purpose

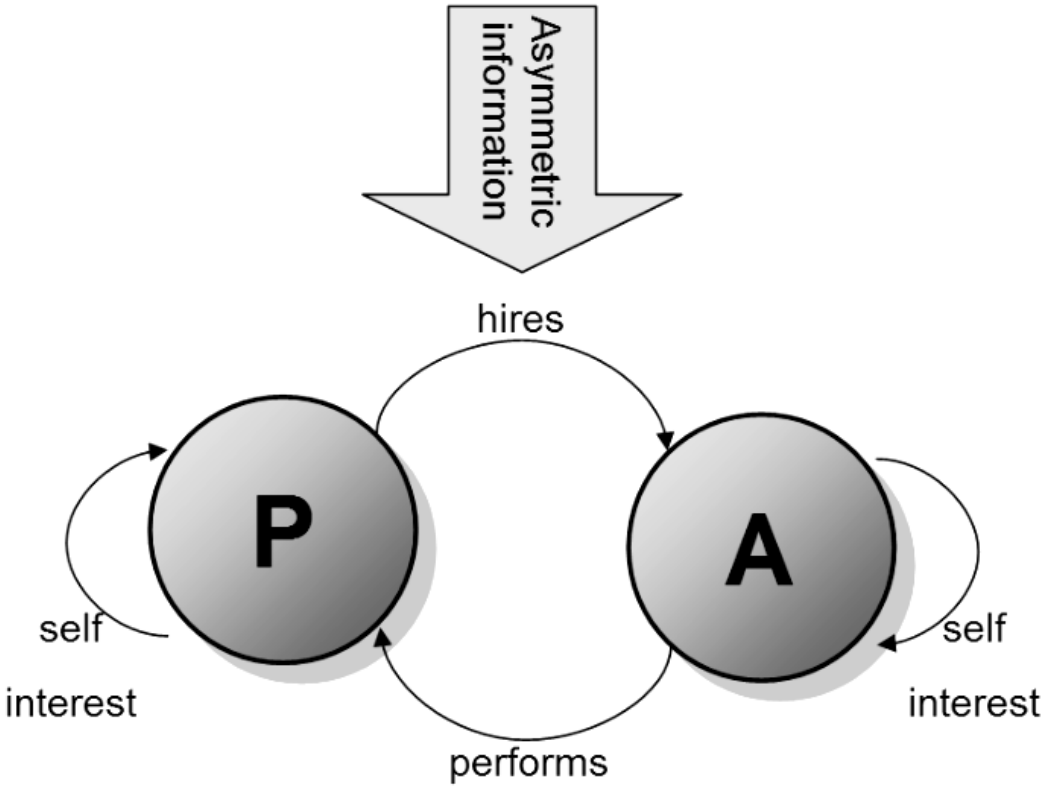
Corporate Governance & Theory of the firm

Corporate Governance

- **What it is:**
  - **a system of rules, policies, and practices that dictate how a company's board of directors manages and oversees the operations of a company.**
  - **Principle – agent model**

Principle-Agent Model

Moral Hazard



Shareholders

Directors

Adverse Selection

Corporate Governance

- **What it is:**
  - **a system of rules, policies, and practices that dictate how a company's board of directors manages and oversees the operations of a company.**
  - **Principle – agent model**
  - **Fiduciary duties of a director**
    - a **duty** to act in the best interests of the company.
    - a **duty** to act within the powers conferred by the company's memorandum and articles of association.
    - a **duty** not to fetter one's own discretion.
    - a **duty** to avoid a conflict of interest, and.
    - a **duty** not to make unauthorised profit.
- **Key principles:**
  - **transparency, accountability, and security.**
- **Poor corporate governance:**
  - **at best, leads to a company failing to achieve its stated goals**
  - **at worst, can lead to the collapse of the company and significant financial losses for shareholders.**

Property Model

- When shareholders invest, they become part owners of the company, or at least of the company's business
- Shareholders have the right to the company's residual income
- This legitimates the shareholders' right to have company run exclusively in their own interest
- Any deviation undermines respect for private property ownership, which requires property be used in the interest of its owners
- Employees = outsiders
- Statutory intervention in the employment bargain = illegitimate intrusion into the private realm of shareholders?

Nexus of Contracts Model

- Company = vehicle for contracting
- Bargaining to reduce transaction costs
- Shareholders provide capital on which they are remunerated
- Ownership right in shares, not company
- Company = 'fiction'
  - legal fiction that serves as a nexus for a set of contracting relations among individual factors of production.
- Ownership of firm = irrelevant concept
- Bargaining and employee consent – no authority relationship between managers and employees
- 'Misleading' to state that 'company owes moral or social responsibilities to employees,' or other third parties.

How to minimize Agency Costs

Property Model

- Commission Payments
- Profit Sharing
- Efficiency Wages
- Performance Measurement
- Fear of Firing
- Enhanced Shareholder rights

Nexus of Contract Model

- View that affording control rights to shareholders is efficient
- Shareholders = group best able to bear risk
- Shareholders have the right to the company's residual income
- Shareholders stand last in line, but enjoy an unlimited right to the surplus
- The group that faces the greatest risk has the most powerful incentive to monitor management

Social Institution Model

- Not adequate to characterize company through ownership/property model or contract model
- Not merely ‘private organizations’ but ‘social enterprises’ which the state influences for the ‘public good’
- Membership and inclusion – move away from shareholder exclusiveness
- Different perspectives
  - Benign managerial model
    - Company’s duty to behave like a good citizen in business
  - The Stakeholder model
    - Need for laws ensuring that the interests of the various constituencies are reflected
  - The Political Model
    - Right of affected groups to be represented

Governance Mechanisms

- Balancing the interests of the different constituency groups
- How to measure management performance?
- Distinguishing management actions resulting from incompetence or the pursuit of self-interest from those motivated by attempts to accommodate the legitimate interests of affected parties
- E.g. two-tier board, representation on boards, incorporation of stakeholder interests in boards' fiduciary duties, mandatory consultation procedures, stakeholder audits

Governance Structure: UK

- Board of listed companies have typically the following positions:
  - Chair of the board
  - Executive directors (CEO and CFO)
  - Non-executive directors
- and the following committees:
  - Remuneration Committee (Chair of the Board and Non-Executive Directors)
  - Audit Committee
  - Nomination Committee
  - Executive Committee of management (CEO, CFO, Secretary of Chair of Board, Business Heads, HR, General Counsel)

Governance Structure: CH

- Flexibility under Swiss law
  - Possibility to delegate responsibility to board members and non-board members.
- Possibility to form committees.
  - Audit
  - Nomination
  - Remuneration *(required for listed limited companies are required to have a remuneration committee (Art. 7 VegüV))*
- Financial Institutions required to have an Audit and Risk Committee (FINMA Circular 2017/1).

The Role of Corporations and the Corporate Purpose

- Legal debate over corporate objective and director duties:
  - In managing or overseeing the management of the firm, whose interests does the law expect directors to take as primary, if any, and what limitations does this impose on directorial decision making?
- Financial & economic debate:
  - how should the "corporation" be modeled in developing a theory of the firm, in evaluating alternative governance arrangements, and in studying the effect of particular changes on firms?
  - "Shareholder value", measured as stock price or market capitalization, is often understood to be a proxy for firm value and sometimes for economic efficiency.
- Management strategy:
  - What is the best strategy for solving the key management challenge, namely, organizing the various participants in the firm to work together as a team to produce great products and services and thereby to build a great company?
- Political debate:
  - the social role of large corporations
  - the obligations imposed on publicly traded (or all) corporations,

The Role of Corporations and the Corporate Purpose

- USA 1931:
  - A. Berle: "[…] [A]ll powers granted to a corporation or to the management of a corporation […] are necessarily and at all times exercisable only for the benefit of all shareholders […]"
- Germany 1930s:
  - Institutional vs Contractual interpetation of the interest of the company
- Milton Friedman : 1970
- Modern debate:
  - The new debate on Shareholder vs Stakeholder Primacy
  - Green economy & Sustainability & SDGs

Milton Friedman:
The birth of Shareholder Primacy

A Friedman doctrine—

The Social Responsibility Of Business Is to Increase Its Profits

By MILTON FRIEDMAN

Friedman: The Social Responsibility of Business is to Increase its profits

- In a free-enterprise, private-property system, a corporate executive is an employee of the owners of the business.
- He has a direct responsibility to his employers:
  - to conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to their basic rules of the society, both those embodied in law and those embodied in ethical custom.
- In some cases his employers may have a different objective:
  - A group of persons might establish a corporation for an eleemosynary purpose--for example, a hospital or a school. The manager of such a corporation will not have money profit as his objectives but the rendering of certain services.
- The key point: in his capacity as a corporate executive, the manager is the agent of the individuals who own the corporation.

Friedman (II): Does the Corporate Executive have a social interest?

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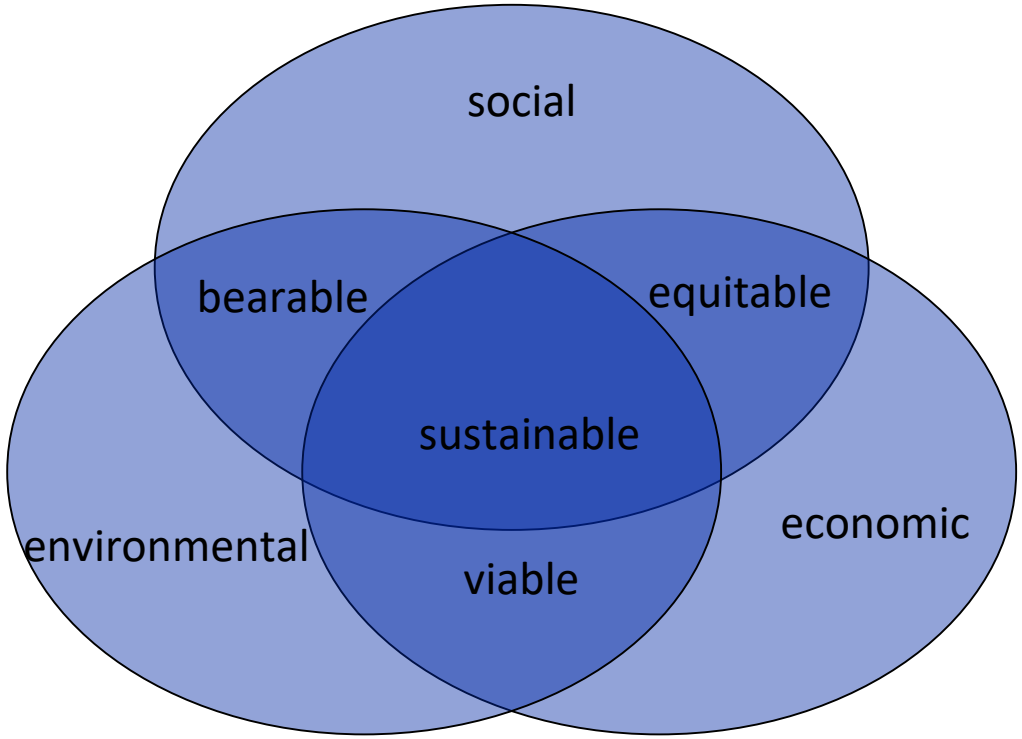
- If we answer yes, he is to act in some way that is not in the interest of his employers. Examples:
  - He does not increase the price of the product to contribute to the social objective of preventing inflation, but a price increase would be in the best interests of the corporation.
  - He makes expenditures on reducing pollution beyond the amount that is in the best interests of the corporation to contribute to the social objective of improving the environment.
  - At the expense of corporate profits, he is to hire "hardcore" unemployed instead of better qualified available workmen to contribute to the social objective of reducing poverty.
- **The corporate executive would be spending someone else's money for a social interest. His actions in accord with his «social responsibility»**
  - **REDUCE RETURNS TO STOCKHOLDERS, SO HE IS SPENDING THEIR MONEY.**
  - **RAISE THE PRICE TO CUSTOMERS, SO HE IS SPENDING THE CUSTOMERS' MONEY.**
  - **LOWER THE WAGES OF SOME EMPLOYEES, MEANS SPENDING THEIR MONEY.**
- The stockholders or the customers or the employees could separately spend their own money on the particular action if they wished to do so.

Milton Friedman (III): Conclusion

- The executive is:
  - exercising a distinct "social responsibility" rather than serving as an agent of the stockholders or the customers or the employees, only if he spends the money in a different way than they would have spent it.
  - But if he does this, he is in effect imposing taxes, on the one hand, and deciding how the tax proceeds shall be spent, on the other.
- This process raises questions on two levels:
  - Political: Imposing taxes and spending the proceeds are governmental functions.
  - Principle-agent:
    - The justification for permitting the corporate executive to be selected by the stockholders is that he is an agent serving the interests of his principal. This justification disappears when the corporate executive imposes taxes and spends the proceeds for "social" purposes.
    - He becomes in effect a public employee, a civil servant, even though he remains in name an employee of a private enterprise.

Friedman as opposed to…? SDGs and CSR



Consequences

- A pressure to move away from Shorterminism
- Embracing Stakeholderism & re-discussing the Corporate Purpose

Ownership in Corp. Gov. & Time Horizon

Short (<2 y) → Medium (<5 y) → Long (>10 y)

Financial Investors

- Hedge Funds
- Asset Managers
- Private Investors
- High-Frequency Traders

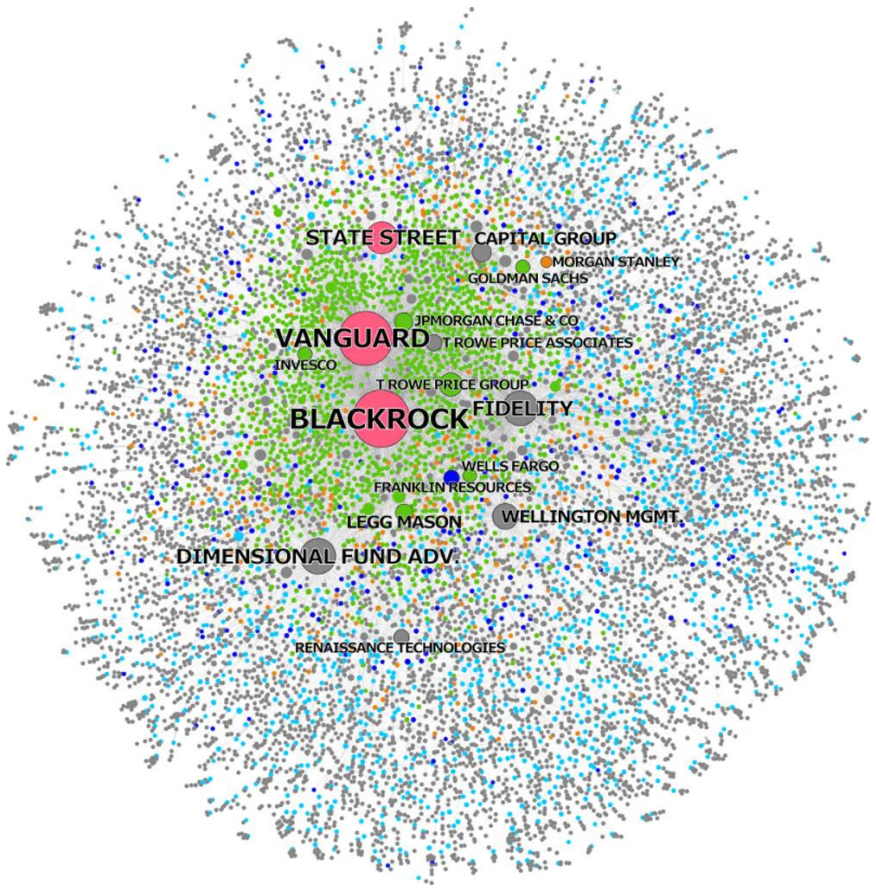
Strategic Shareholders

- Private Equity
- Institutional Investors

Long-Term Owners

- Founders
- Families
- Foundations
- Coops/Mutual Companies

The rise of Passive Funds



-Total Inflows 2009-2018

Index (Passive) Funds

$ 3.4 trillion

-Total Inflows 2009-2018

Actively Managed Funds

200 billion

Shorterminism

- An excessive focus on short-term results and not long-term interests.
  - An excessive focus of investors on quarterly earnings
  - No attention paid to strategy, fundamentals and long-term value creation.
- Corporations too often respond to these pressures by:
  - reducing their expenditures on research and development and/or foregoing investment opportunities with positive long-term potential.
- These decisions can weigh against companies' development of sustainable products or investment in measures that:
  - deliver operational efficiencies
  - develop their human capital
  - effectively manage the social and environmental risks to their business.

Shareholder Activism

- "Activism": a range of activities by one or more of a publicly traded corporation's shareholders that are intended to result in some change in the corporation.
- The spectrum of activities:
  - based on the significance of the desired change and the assertiveness of the investors' activities.
  - On the more aggressive end of the spectrum is hedge fund activism that seeks a significant change to the company's strategy, financial structure, management, or board.
  - On the other end of the spectrum are one-on-one engagements between shareholders and companies triggered by Dodd-Frank's "say on pay" advisory vote.

Consequences

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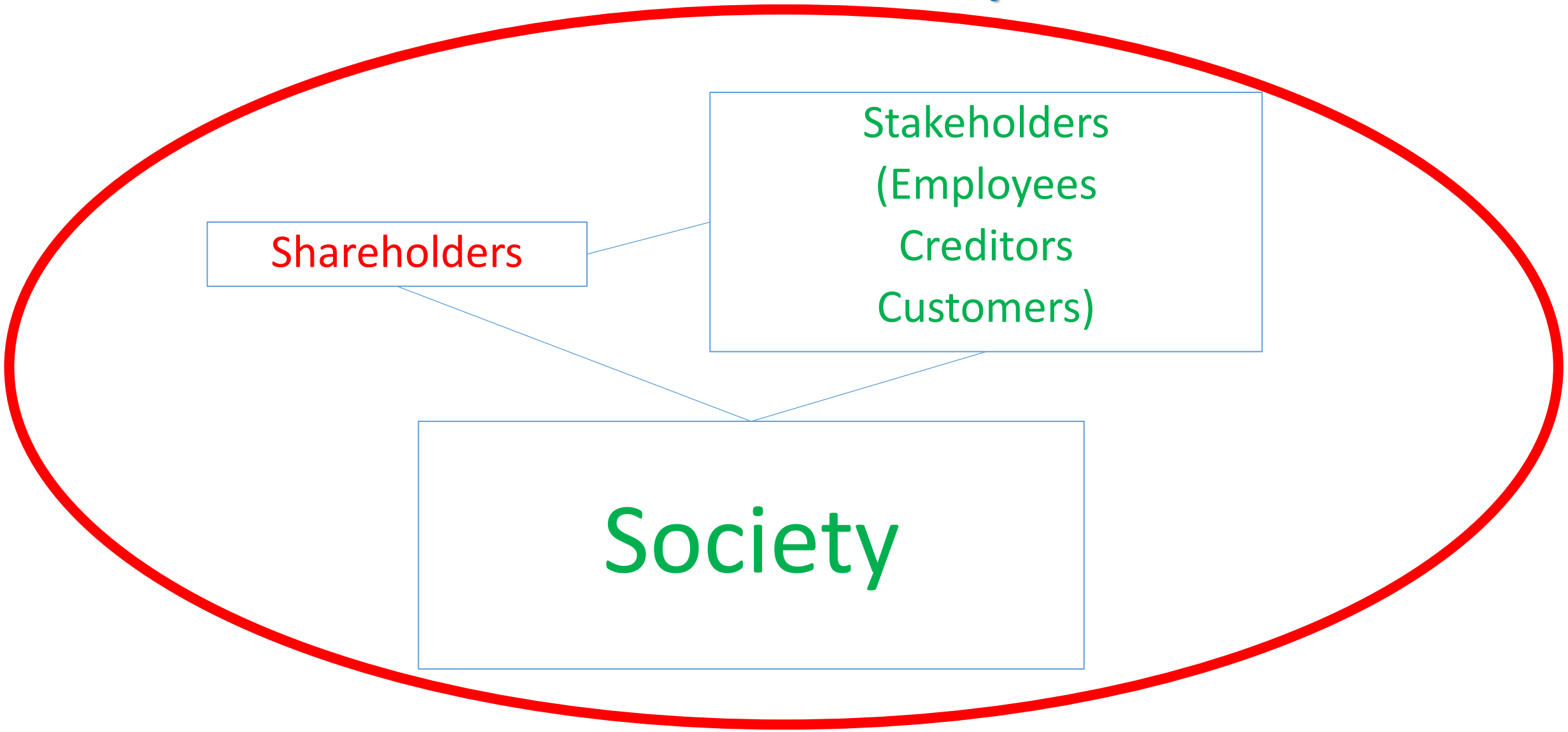
The debate on the Corporate Purpose

- Legal debate over corporate objective and director duties:
  - In managing or overseeing the management of the firm, whose interests does the law expect directors to take as primary, if any, and what limitations does this impose on directorial decision making?
- Financial & economic debate:
  - how should the "corporation" be modeled in developing a theory of the firm, in evaluating alternative governance arrangements, and in studying the effect of particular changes on firms?
  - "Shareholder value", measured as stock price or market capitalization, is often understood to be a proxy for firm value and sometimes for economic efficiency.
- Management strategy:
  - How best to build valuable and sustainable firms. What is the best strategy for solving the key management challenge, namely, organizing the various participants in the firm to work together as a team to produce great products and services and thereby to build a great company?
- Political debate:
  - the social role of large corporations
  - the obligations imposed on publicly traded (or all) corporations,
  - whether current economic arrangements are politically legitimate and sustainable.

Stakeholderism

- Corporate governance should take into account interests of all stakeholders.
- Stakeholderism as extension of shareholder primacy (enlightened shareholder value / instrumental stakeholderism).
    - Maximizing long-term shareholder value depends also on stakeholder interests.
    - E.g. 2006 UK Companies Act: Factors to consider when enhancing shareholder value include Companies employees and impact on community and environment.
  - Pluralistic Stakeholderism
    - Stakeholder welfare as independent purpose from shareholder interest.

Towards a universal corporation?



The impact of Stakeholderism

- Blackrock 2018:
  - Society is demanding that companies, both public and private, serve a social purpose. To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate.
- Business Roundtable 2019:
- Blackrock 2020:
  - https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter
- World Economic Forum 2020:
  - *Stakeholder Capitalism: A Manifesto for a Cohesive and Sustainable World*

The Business Roundtable: 1997 vs 2020

- 1997
  - In The Business Roundtable's view, the paramount duty of management and of boards of directors is to the corporation's stockholders; **the interests of other stakeholders are relevant as a derivative of the duty to stockholders**. The notion that the board must somehow balance **the interests of stockholders against the interests of other stakeholders fundamentally misconstrues the role of directors**. It is, moreover, an unworkable notion because it would leave the board with no criterion for resolving conflicts between interests of stockholders and of other stakeholders or among different groups of stakeholders.
- 2019:
  - https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans

UK : Company Act – Section 172
Duty to promote the success of the company

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- (1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to—
  - (a) the likely consequences of any decision in the long term,
  - (b) the interests of the company's employees,
  - (c) the need to foster the company's business relationships with suppliers, customers and others,
  - (d) the impact of the company's operations on the community and the environment,
  - (e) the desirability of the company maintaining a reputation for high standards of business conduct, and
  - (f) the need to act fairly as between members of the company.

Impact at EU Level

- **European Commission Action Plan (2018)**
  - https://www.unpri.org/sustainable-financial-system/the-european-commission-action-plan-action-10/3010.article
- **Europe's moment: Repair and Prepare for the Next Generation (2020)**
  - **4. REPAIR AND PREPARE THE NEXT GENERATION: THE POLICY FUNDAMENTALS**
    - **THIS DISRUPTIVE AND CHANGING CRISIS IS FIRST AND FOREMOST A HUMAN TRAGEDY. […] WE MUST INVEST IN: PROTECTING AND CREATING JOBS AND IN DRIVING OUR COMPETITIVE SUSTAINABILITY BY BUILDING A FAIRER, GREENER AND MORE DIGITAL EUROPE. WE MUST REPAIR THE SHORT-TERM DAMAGE FROM THE CRISIS IN A WAY THAT ALSO INVESTS IN OUR LONG-TERM FUTURE. TO ACHIEVE THIS, THE EU MUST NOW SHOW CLARITY OF PURPOSE AND CERTAINTY OF DIRECTION THROUGH ITS POLICIES.**
    - To ensure environmental and social interests are fully embedded into business strategies, the Commission will put forward a new initiative in 2021 on sustainable corporate governance.

The EU Approach

Supply Chain

Consultation
30 July 2020 –
8 October 2020

Consultation
26 October 2020 –
8 February 2020

Sustainable Corporate Governance Initiative?

Proposal for a Directive (Q2 2021)

Legislation on sustainable Corporate Governance will be proposed to foster long-term sustainble and responsible corporate behaviour»

Commission Work Programme 2021 A union of vitality in a world of fragility

Brussels, 19.10. 2020

COM (2020) 690 Final

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EY for the EU: Study On Directors Duties

Problems	Solutions
Directors' duties and company's interest are interpreted narrowly and tend to favour the short-term maximisation of shareholder value;	Specify in company law that directors may give priority to company purpose and stakeholder interests, particularly in takeover situations.
Growing pressures from investors with a short-term horizon contribute to increasing the boards' focus on short-term financial returns to shareholders at the expense of long-term value creation;	Strenghten long-term Owenrship – by families, foundations, and coops/mutuals
Companies lack a strategic perspective over sustainability and current practices fail to effectively identify and manage relevant sustainability risks and impacts;	Sustainability Committees on Boards
Board remuneration structures incentivise the focus on short-term shareholder value rather than long-term value creation for the company;	Long-term board compensation by resticted stock > 10 years (or fixed pay)
The current board composition does not fully support a shift towards sustainability;	Sustainability Committees for streghtening sustainability competencies (biology, engineering, science)
Current corporate governance frameworks and practices do not sufficiently voice the long-term interests of stakeholders;	Advisory Stakeholder Councils that prioritize outsiders (costumers and suppliers)
Enforcement of the directors' duty to act in the long-term interest of company is limited.	Strenghten company purpose and board representation by long-term shareholders.

Institutional Investors & Asset Managers role?

- Sir Christopher Hohn, TCI Fund – The Children's Investment Fund ($28 billion under management)

- "Asset owners should fire asset managers that do not require disclosure on environmental risk,"
- "Major asset managers such as BlackRock have been shown to be full of greenwash,"
- Asset Management and Climate Change (Dec 2019):
  - BlackRock and Capital Group were the least supportive out of the world's 15 largest asset managers of climate-related shareholder resolutions which were covered in the study

Institutional investors and ESG risks

- Hohn/TCI has outlined plans ‘to punish directors of companies that fail to disclose their carbon dioxide emissions in a move that underlines rising investor concerns over climate change and the pressure on boardrooms to respond.’
- TCI warned Airbus, Moody’s, Charter Communications and other companies to improve their carbon/pollution disclosures or it will vote against their directors and called for asset owners to fire fund managers that did not insist on climate transparency
- “Investing in a company that doesn’t disclose its pollution is like investing in a company that doesn’t disclose its balance sheet,” “If governments won’t force disclosure, then investors can force it themselves.”
- Investors “can use their voting power to force change on companies who refuse to take their environmental emissions seriously. Investors have the power, and they have to use it.”

Multinational corporations/State-owned Enterprises (SOEs) and CSR

- MNCs/SOEs are driving increased foreign direct investment in developing and other vulnerable economies (post-conflict countries PCCs)
- 2019: 4 of the world's largest corporations are SOEs
- SINOPEC group, China National Petroleum, State Grid
- (China-owned power company), and Saudi Aramco
- Many SOEs are focusing more FDI in PCCs
- SOEs coming under pressure to act like 'responsible citizens'
- Many host states adopt CSR laws (require foreign MNEs to invest in community projects to obtain a license to operate)
- - Indonesia's 1956 Production Sharing Agreement, Nigeria (2007 Extractive Industries Initiative), India (2013 Companies Bill), and Peru (2014 Mining Canons)

Swiss Responsible Business Initiative

Proposal of a new Art. 101a FC (Federal Constitution)

- **Mandatory due diligence** of Swiss based companies on subsidiaries based abroad (three steps):
  - Swiss parent companies must first review all their business relationships and activities with a view to **identifying potential risks** to people and the environment.
  - They must **take effective measures** to address the potentially negative impacts identified.
  - As a third step, companies are required to **repor**t in a transparent manner on the violations identified, as well as on the related measures taken.
- **Liability provisions**
  - Swiss based companies will be liable for human rights abuses and environmental violations caused abroad by companies under their control in front of Swiss Courts.
  - **Exemption** from liability when the company credibly demonstrates to the Court that it carried out adequate due diligence and that it took all necessary measures to prevent the violations.
- These provisions are stricter than the existing Swiss law on the liability of parent companies acting as de facto corporate organs of their subsidiaries (Art. 754 CO)

Conclusions

- Company = vehicle for contracting and bargaining to reduce transaction costs
- Principal-agent model informs corporate governance
- What about stakeholders? Who are the stakeholders?
- What legal obligation owed to stakeholders? How should it be determined?
- The role of Institutional Investors
- Multinational enterprises and cross-border operations
- How company legal duties determined in international context?
- Is it 'misleading' to state that 'company owes moral or social responsibilities to employees,' or other third parties?

Putting Stakeholders first: It's difficult!

- Johnson & Johnson "Credo" in 1943
  - Robert Wood Johnson describes his company's responsibilities in this order: patients/doctors/nurses, customers, business partners, employees, communities, the environment and natural resources, and *then,* after all that, "stockholders should realize a fair return."
- 2019: A judge had ruled against the company, fining it $572 million for its alleged contribution to the opioid crisis in Oklahoma.
- Even if J&J appeals successfully, the situation shows that
  - (a) companies are increasingly expected to play a positive role in society and take responsibility for the broader effects of their actions and products, and
  - (b) companies are complicated — their actions and words don't line up perfectly. A company can have the right principles on paper but, at times, lose sight of what serving multiple stakeholders really means.

Putting Stakeholders first: It's difficult!

- Amazon: increased burning depends on policies to help industrial agriculture and meat industries, all enabled by a Brazilian president that *wants* to monetize natural capital.
- What responsibility do businesses have to prevent this degradation?
  - Presumably, companies signing a statement like the BRT's wouldn't buy from meat suppliers that burned down the Amazon to create grazing lands.
  - And companies that truly put stakeholders and long-term needs ahead of short-term investors would proactively fight these kinds of devastating policies. In a similar vein, signatories should become loud, vocal advocates for a price on carbon.

Putting Stakeholders first: It's difficult!

- Signatories have fought any action on climate, even while making public statements in support of a price on carbon. This isn't ancient history.
- In the 2018 election, a ballot initiative in Washington state proposed a modest carbon price. Money poured in from fossil fuel interests, including many of the BRT signatories, to defeat the initiative.