Institute for governance
of private and public organizations

Background and potential questions for a private session with CEOs: *A dialogue on the role of business*

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Toward Value-Creating Governance™

Introduction

Business is a risky endeavor with an uncertain life expectancy. It has been, and should remain, a driver of innovation, a creator of wealth, a harbinger of economic freedom. The core mission of a profit-driven enterprise is not to fulfill some philanthropic duty. But it is not either solely to maximize short-term shareholder value.

The fundamental role of business has remained relatively constant: providing the goods and services that people need or want. What has changed dramatically over time are the expectations placed on business firms. Boards of directors, management, investors of large corporations are now expected to address an array of social/economic/ecological challenges

Business derives its social legitimacy and right to operate from the economic value it creates for the broader society, from its performance for both investors and a wider network of constituencies, from its partnership with governments and other agents in solving social problems, and from the transparency of its operations and actions.

For a period of time, say to 1980, most large business corporations did abide by the belief that "making money for shareholders" was not the be-all and end-all of business. In fact, the notion that business had a higher purpose than generating profits is rooted in some of the earliest business endeavors. It is manifest in a famous exchange between Henry Ford and the lawyer for the Dodge brothers who were suing Ford for slashing prices of the Model T:

"*What*," he [Dodge's lawyer] asked Ford, "*is the purpose of the (Ford) company?*"

"*To do as much possible for everybody concerned*," responded Ford, "*to make money and use it, give employment, and send out the car where the people can use it … and incidentally to make money …Business is a service not a bonanza.*"

"*Incidentally make money*?" queried the attorney.
"*Yes, sir*."
"*But your controlling feature … is to employ a great army of men at high wages, to reduce the selling price of your car, so that a lot of people can buy it at a cheap price, and give everybody a car that wants one*."
"*If you give all that,"* replied Ford, *"the money will fall into your hands; you can't get out of it."* [Footnote 1]

Yet, over the last three decades, the *stakeholders* model of the corporation was, in many instances, discarded and replaced by a shareholder-centric view of the corporation. The drivers of this shift are multiple, very dynamic and difficult to contain. An ideology of market efficiency certainly played a role but so have changes in compensation models throughout the economic system.

The dominant discourse claimed that free and global markets for capital, goods, services and people were the wave of the future, that "shareholder value-creation" was the essential, sometimes the only, goal of stock-market listed corporations.

The result, overall, has not been very good: too much greed infecting economic activities; recurring financial crises and business fiascos eroding trust in organizations, in public institutions and in their leadership; rising inequality; reduced social mobility; short-term profit maximization in every nook and cranny of the economic system; benign neglect of social problems; the pauperization of workers in developed economies [Footnote 2].

A healthy society, and an effective organization for that matter, must find ways to balance and reconcile in its bosom the "humanist" and the "economist" who live in every one of us. The *stakeholders* model of the corporation did strike a delicate balance of the economic and humanist imperatives. Can it be

reinstated, in contemporary guise, as a business model for the future?
The case for a renewed commitment to the stakeholders that bestow legitimacy on business firms is a compelling one, even to many who benefit mightily from the current state of affairs.

The issue, and the formidable challenge, resides in the means to bring about this transformation of financially driven businesses into ***"purpose-driven" corporations***.

To begin at the beginning, a shift in the ideological underpinning of our economic system must occur, a sort of widespread epiphany about what will be our collective fate and that of future generations if we continue on our present course. The World Economic Forum is actually an agent to produce such epiphanies. Many businesses are already driven by a higher purpose but there are several impediments to a widespread transformation of our economic and financial system.

Three interconnected themes seem to capture the essence of discussions and debates about the role of business in the 21st century:

1. **How can trust in business organizations and their leadership be re-built?**

All indicators show a sharp drop in the trust bestowed on most institutions over the last twenty years. The most recent Edelman Trust Barometer, while noting some improvement over the last year, still paints a sorry picture: overall trust in business and government stand at 50% and 41% respectively worldwide; that is a disturbing datum but even worse is the level of trust in the leadership of business and government, which stands at a dismal 18% and 13% respectively!

When respondents are asked to identify the reasons for trusting business less, some 50% point to "corruption/fraud" and "wrong incentives driving business decisions"; when asked the same question for government, 50% indicate "corruption/fraud" and "poor performance/incompetence".

The Pew Research Center also reports on variations in the favorability ratings of business in the United States. From 1985 until 2001-2002 the years of the Enron/WorldCom et al. scandals, business had a favorability score hovering between 60% and 72%. It then fell swiftly to the 50% level, to drop, after the 2008 financial fiasco, to 38% by 2012.

Trust does matter a great deal. From trust flows legitimacy. Without legitimacy, businesses may lose their franchise to operate. Without legitimacy, leadership is weak and ineffective.

- How can business leaders regain/maintain the trust of the general population, of public decision-makers and of people within their own organization?

- Would clearer and more vigorous commitment to sustainability, a different sharing of benefits within the company, more transparency and accountability, different trade-offs between shareholders and other stakeholders help in gaining back the trust of the people? Or, will the issue simply vanish as the memory of business fiascos fades away?

- Are the current laws, monitoring organizations and enforcement apparatus enough to convince citizens that corrupt practices are in check and that international dealings are carried out in a fair and honest manner?

2. *What* should *be done to combat short-termism in the management of corporations?*

Short-termism in management has been lamented by many experienced observers of our economic system.

Some years ago, John Reed, the former co-CEO of Citigroup was indicting what he called the "iron triangle of short term pressures": *financial analysts, stock options and hedge funds*.

Currently, the triangle might be described thusly: *the fear of missing out on earnings expectations*, *poorly designed compensation systems*, *activist and short-term funds.* [The median holding period of shares for U.S. institutional investors hovers around 1.8 years (holding steady since 1985) and 69% of shares are held for less than one year (Chakrabarty, Moulton, Trzcinka, 2012)].

Compounding the impact of these very real contingencies for widely-held, listed corporations are changes in corporate governance to give more power to activist shareholders and a freer hand for hostile acquirers. Then, as well, proxy advisors have gained influence and often threaten board members with negative voting recommendations if the directors do not toe their lines on corporate governance.

[A debate is currently raging in the U.S. about whether hedge funds are really short-term investors and whether more power should be given to shareholders (viz. Bebchuck v. Lipton]

Large institutional funds (university endowments, public and private pension funds in particular) are called upon to hold on to the shares for a longer period and use their leverage to support a longer perspective in the management of companies. Yet, they also have a fiduciary responsibility to maximize risk-adjusted returns to their own members/contributors. The key challenge here is to show that a longer term investment perspective brings superior risk-adjusted returns [Footnote 3].

- Has this demonstration been made in a compelling manner?
- How can institutional investors move from passive, short-term holders of shares to a more engaged posture?
- What role does executive compensation play in triggering a short-term horizon and what can institutional investors do about it?

- What sort of performance measurement and compensation system would support a higher purpose and longer horizon for the company?
- What is a fair balance between the rights of shareholders and the legal authority of the boards to support longer-term strategies and investments that may be questioned by some significant shareholders?
- Should institutional investors look more favorably on alternative forms of ownership: e.g. privately owned companies or dual class of shares used by entrepreneurs and family companies to maintain control and a longer planning horizon (e.g. Google, Facebook, Berkshire Hathaway)?
- Should they view favorably legal provisos such as that adopted by the Swiss corporate law which allows a listed corporation to limit voting power to 5% whatever the level of shareholding (e.g. Nestlé)?
- How can institutional investors help corporations move away from the dictatorship of quarterly earnings guidance and consensus?
- How, and should, institutional investors, as clients of proxy advisors, ensure that these entities play a useful role in lengthening management's time horizon?

3. *What role should governments and regulations play to create a favorable environment for stakeholders-driven companies?*

Economic systems are always the joint product of law and ideology. As the legal framework evolves under the influence of an ideological shift, new ways of acting and behaving come to the fore. New motives, purposes and aspirations become prevalent and the game of economic life changes.
Governments wield a lot of power to influence corporate behavior through regulation and tax policies. Indeed, the Dodd-Frank act in the U.S.A. mandates that listed corporations

let shareholders vote on executive pay and divulge the ratio of the CEO's total compensation to median earnings of company employees. Both measures, already in place or likely to be copied in several jurisdictions, are fraught with implementation issues and are questioned as to their real effectiveness.
Governments also define the role and responsibility of boards of directors. In several U.S states as well as in Canada and other jurisdictions, boards must act in the long-term interest of the company (not of its shareholders or any other particular stakeholder).

- Should governments everywhere make clear that boards of directors have a fiduciary responsibility for the long term wealth of the company as well as duty of care for all stakeholders (not only shareholders)?
- Should governments grant to the board of directors the power to "just say no" to a hostile takeover, as was done in several U.S. states?
- Should governments mandate more transparency in matters of sustainable development? [Footnote 4]
- Is there a risk of regulatory arbitrage by transnational companies?
- Should governments enact measures that would support longer-term holding of shares for instance:
  - ✓ by modulating capital gains tax to holding period,
  - ✓ by allowing for a minimum holding period before acquiring the right to vote the shares,
  - ✓ by reviving the SEC proposal (rejected by U.S. courts), which would have permitted shareholders or shareholder groups who owned not less than 3 percent in voting power of a U.S. public company ***for at least three years*** to include their nominees (up to 25 percent of the board) in the company's proxy materials.]
  - ✓ etc.?

- Should governments set policies that support and facilitate the development of alternative ownership structures: cooperatives, mutuals, employee-owned companies, family-owned private companies, etc.?
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Conclusions

The long-term success and survival of a business depends, or will come to depend, on its ability to create value for its many stakeholders, on its pro-activity in coping with the social and environmental consequences of its operations.

There are no villains in this story, rather a system of ideas, pressures and incentives has come about which we must understand and change. What changes in which part of the current economic system are most likely to bring some movement in the right direction? Are there prime movers in the system? In other words, are there fundamental causes to the current state of affairs, which, if not directly addressed and changed, will thwart any effort at reform?

No one can know how the next ten years are likely to unfold, but as the world's problems grow increasingly pressing, it is clear that the world of 2024 will not look like the world of 2014.

Already thousands of companies understand that financial success can only be sustained if the firm also creates social, environmental and ethical value. These firms are drawing on universal principles in areas such as human rights, labor, the environment and anti-corruption to redefine their strategic and operating models, and they are exploring new disclosure and reporting standards in order to drive a "race to the top". New forms of collaboration across industries, governments and civil society are emerging to shape the market conditions for entire industries, to bring about *purpose-driven* businesses.

1. Quoted in *The Economics of Higher Purpose*, A.V. Thakor and R. E. Quinn, December 2013, ECGI working paper #395).

2. There is some tentative evidence to that effect, viz. Cremers, Pareek, Sautner (2012).

3. According to the U.S. Bureau of Labor Statistics, average weekly earnings and average hourly earnings in constant dollars in 2010 *were significantly lower* than in1975.

4. For instance, the SEC, mandated by the Dodd-Frank Act, will henceforth require all resource extraction companies listed on a U.S. exchange to include in an annual report information relating to any payment made by the issuer, a subsidiary of the issuer, or an entity under the control of the issuer, to a foreign government or the Federal Government for the purpose of the commercial development of oil, natural gas, or minerals. This measure will likely be contested in courts but it is a significant, perhaps troubling, development.