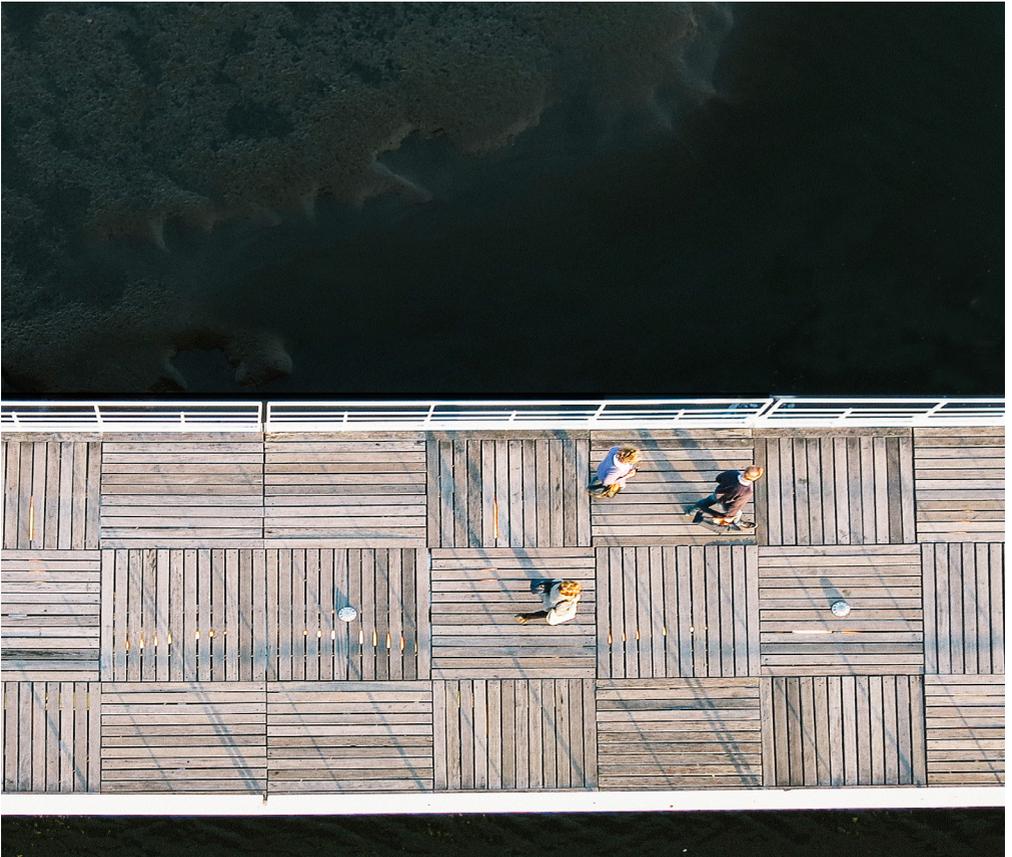


Corporate Governance for a Changing World

Executive Summary of the
Global Roundtable Series Report



**Frank
Bold**



Authors: Jeroen Veldman, Filip Gregor and Paige Morrow

Design and layout: Susanna Arus

Research assistant: Jean-François De Hertogh

About Frank Bold:

Frank Bold is a purpose-driven law firm established in 1995 with four offices in the Czech Republic as well as offices in Brussels, Belgium and Krakow, Poland. The firm uses both business and non-profit approaches to solve social and environmental problems. Frank Bold provides legal expertise in corporate accountability and corporate governance to the European institutions as well as to civil society, municipalities, and businesses.

About the Purpose of the Corporation Project:

In recent decades, a consensus has begun to emerge that corporations should focus on creating long-term sustainable value but that we lack clear vision on how to achieve this outcome. In order to produce more clarity on appropriate structures and practices for publicly listed corporations, Frank Bold initiated the Purpose of the Corporation Project to provide a strategic, open-source platform for leading experts and organisations to develop new options for corporate governance models.

Further information is available on the project website:

www.purposeofcorporation.org.

This executive summary presents the main conclusions of the roundtable series but the views expressed in this report are solely those of the authors.

Section I

Introduction

Perhaps the most important question for the economy is thinking through how corporations should be managed and for what ends. Today we face complex challenges that cannot be addressed by governments or civil society alone, such as growing inequality, climate change, doing business within the limits of the planet's resource boundaries and negotiating the complicated relationship between economic globalisation, development, and human rights. As corporations form the fabric of contemporary economies, corporate governance systems are central to the way economies function and are of critical importance for engaging with these issues.

In 2014, the Purpose of the Corporation Project, with the support of the Modern Corporation Project at Cass Business School, launched the Corporate Governance for a Changing World Roundtable Series (“roundtables” or “roundtable series”) with events in Breukelen (the Netherlands), Brussels, London, New York, Oslo, Paris, and Zurich that brought together more than 260 thought leaders in business management, investment, regulation, academia and civil society. The roundtable participants identified the key outcomes of corporate governance towards which we should be moving, as well as potential barriers and best practices for how to reach the desired outcomes.

The roundtables sought to answer a number central questions, the results of which are synthesized in this report:¹

- How can corporate governance contribute to robust long-term value creation for companies?
- What is the role of stakeholders, including shareholders, in fostering a long-term focus on sustainable behaviour?
- What incentives for short-termism exist in law, corporate governance codes and business practice?

This executive summary synthesises the reflections on these questions and best practices from all roundtables. The sections reflect the main issues that were raised during the discussions.

¹ All footnotes have been omitted from this executive summary. The references and relevant resources may be consulted in the primary report, which is viewable at www.purposeofcorporation.org/corporate-governance-for-a-changing-world_report.pdf

Section II

Framing of current debates on corporate governance

Summary

Over time, different corporate governance models have been created to answer the questions how, by whom, by what and for whom corporate governance should organise the procedures and processes that direct and control business. From the 1970s onwards, mainstream corporate governance models have narrowed until the purpose of the corporation has become equated with the maximisation of shareholder value. The narrowing in perception of the legitimate scope of corporate purpose and managerial discretion has prompted boards and executives to adopt short-term strategies that increase the payout ratio to shareholders. This is mostly done by raising the proportion of corporate profits spent on dividends and share buybacks, by engaging in mergers and acquisitions, and by externalising costs. The relatively recent trend toward excessive risk-taking is at the expense of other stakeholders and of long-term value creation.

The shift towards shareholder value and short-term strategy has had a number of adverse effects on corporations and on broader society, and has contributed to the following trends:

- Reallocation of risks and rewards to a small percentage of corporate constituencies, contributing to growing inequality.
- Undermined corporate resilience and diminished ability to create value over the long-term and to invest in R&D and human and social capital.
- Slower corporate innovation and economic growth.
- Diminished capacity to anticipate and mitigate systemic risks that threaten the whole of society, such as climate change and financial crises.
- Reduced potential for corporations to play a beneficial role in society.

Recommendations

Roundtable participants recognised that shareholder primacy is a problematic model for corporate governance. It induces short-termism and leads to a disconnection between short and long term goals in business strategy. The roundtables concluded that the role of corporate governance is not only to protect the corporation but also to ensure that a corporation is able to create long-term sustainable value for society at large. Moreover, the roundtables

clearly expressed the need to build a stronger corporate governance model, which should aim to:

- Create real value for customers and wealth for shareholders as joint and mutually reinforcing objectives.
- Take account of environmental sustainability and societal well-being.
- Identify and respond to systemic risks and opportunities.
- Adopt both financial and ESG benchmarks to measure corporate performance over the long-term

Section III

Engaging with corporate governance

Summary

The purpose of the corporation is central to the way a corporation operates. The definition and interpretation of corporate purpose determines a corporation's ability to recognise, respect, and balance stakeholder needs, which are key to its long-term success, to its ability to operate in line with societal interests, and to maintain public trust and its social license to operate. However, corporate governance practice and regulation have been increasingly built on the narrow principle that the purpose of the corporation is to prioritise shareholders' interests. This conception contributes to a short-termism that is harmful to the corporation as well as to society at large. It is not supported by corporate law, which makes the corporate entity the beneficiary of fiduciary duties, and allows (but in many jurisdictions does not require) a much broader perspective on the purpose of the corporation.

The roundtable participants argued that from a practical point of view the generic purpose of the public corporation is to be successful over a long period and in doing so it ought to satisfy the interests of all relevant stakeholding constituencies. This perspective should follow from and be embedded in corporate governance.

Recommendations

The roundtables identified several options for corporations on how to protect their purpose:

- Embed a clear statement of purpose and corresponding rights and responsibilities of directors, shareholders, and other stakeholders in governance documents and articles of incorporation.

- Use dual-class share structures with differentiated voting rights, where available.
- Vest voting shares in a foundation established to oversee the corporation's purpose.
- Register as a Benefit Corporation or other alternative legal form established to protect social purpose, or alternatively, obtain B corporation certification.

The roundtables also identified how corporate law and corporate governance regulation can foster purpose driven corporations. Accordingly, the legal framework could:

- Clarify in law and in corporate governance codes the societal purpose of corporations and their duties toward internal and external constituencies.
- Allow corporations to protect their purpose in governance documents and arrangements.
- Require corporations to specify their long-term social purposes in their constitutional documents.
- Recognise a director duty to develop long-term plans in order to meet specific societal objectives relevant for their corporation, and annually report to shareholders on how these plans are being fulfilled.
- Allow for the use of dual class share structures and industrial foundations.

Section IV

Fiduciary duties of directors and institutional investors

Summary

There are two distinct forms of fiduciary duties that are relevant to improving corporate governance:

1. those of corporate directors to promote the success of the corporation, which are owed to the corporation itself; and
2. those of institutional investors (such as pension fund trustees) to act in the interest of their beneficiaries, which are owed to those beneficiaries.

The roundtables confirmed that corporate directors, as well as institutional investors, are legally permitted to take environmental, social and governance

(ESG) factors into account. Furthermore, in all jurisdictions, directors are under an obligation to proactively and critically evaluate the material financial risks and opportunities to their corporation.

Similarly, institutional investors invest mostly on behalf of broad sets of end beneficiaries with a long-term horizon (such as pensioners). As the duties of institutional investors are, in principle, long-term oriented, they should take account of the long-term viability of the systemic context in which their investments are made. Additionally, investors should be expected to provide monitoring and engagement that will support long-term value creation for corporations and their own beneficiaries, whether institutional investors invest directly or rather through asset managers.

In practice, the expectation of boards and institutional investors to adopt a broader concept of fiduciary duties is undermined by the prevailing corporate governance model. This model puts pressure on all parties, including boards and institutional investors, to focus on the short term. The failure to adopt a broader interpretation of fiduciary duties carries a number of risks: direct business and physical risks, regulatory risk, risk of shareholder and stakeholder litigation, as well as a potential risk to reputation. These risks may undermine the long-term viability of corporations.

Recommendations

The roundtable participants identified several recommendations for how fiduciary duties can be used to restore the focus on long-term value creation:

Recommendations for corporations and their directors

- Clearly acknowledge and publicly affirm that it is the duty of directors to:
 - Protect the long-term development of the corporation;
 - Evaluate salient environmental and social risks connected to the business of their corporation;
 - Mitigate negative impact on corporate stakeholders and society at large and to specify how stakeholders' interests should be taken into account; and
 - Assess and address systemic risks associated with the corporation.
- Reflect these duties and set objectives in corporate governance documents, strategic objectives, KPIs, corporate reporting and executive incentive systems.

- Integrate systemic risks, sustainability and other relevant ESG factors into 'in control' statements.

Recommendations regarding the fiduciary duties of institutional investors

- Develop a strategy taking account of ESG matters, systemic risks, and engage with the boards of investee corporations, reflecting end-beneficiaries' long-term interest and time horizons for the investment strategy. Integrate this strategy in internal incentive schemes.
- Support engagement and/or disengagement strategies, as well as positive publicity campaigns.
- Request that investee corporations integrate ESG factors in their reporting.
- Align the strategy of agents down the investment chain with the specific investment strategy set by the institutional investor.

Recommendations for policy-makers

- Clarify the content of fiduciary duties with respect to specific environmental and social issues relevant for particular industries, e.g. systemic financial stability in the case of banks, the mitigation of environmental impacts for extractive corporations, and the development of fair and sustainable supply chain models for apparel corporations.
- Clarify the liability of directors for serious impacts caused or contributed to by the corporation.
- Require greater transparency by investors regarding their engagement strategy with respect to ESG risks.
- Clarify the role and responsibilities of fund managers and proxy advisers.

Section V

Broader purpose and the board

Summary

Boards play a key role in setting and steering corporate strategy. They influence crucial factors like corporate values, corporate culture, and risk appetite, and determine the attentiveness of the corporation to the interests of its stakeholders and purpose. In order to effectively fulfil their role, boards must consider the corporate mission and long-term value creation strategy, have a good overview of

the interests of the corporation's stakeholders, understand and assess relevant risks, and decide on the objectives of the compliance and due diligence systems. There are a number of options for how boards may be organised in order to encourage them to pursue a broader and longer-term view of corporate purpose but it is important to recognise that each corporation is different. Some corporations and their markets may require more stability, while others must innovate rapidly in order to remain competitive. Their shareholder base may be fragmented or they may have a controlling shareholder, who may or may not be very actively involved in the corporation's management.

Recommendations

The roundtable participants identified several good practices that corporations may consider to improve the ability of their boards to operate with a view to a broader purpose of the corporation:

- Boards should be explicitly responsible for setting the corporation's mission and its long-term value creation strategy, overseeing a stakeholder consultation, providing a statement on the assessment of systemic risks, and investigating complaints of major wrongdoing by the corporation.
- Non-executive directors could serve to ensure regard to the interests of specific stakeholders and bring competencies to the board that relate to those stakeholders. To discharge this role effectively, the mandate of the non-executive director must be clearly specified and framed with respect to the overall responsibility to the corporation.
- Boards can develop an active policy of encouraging investment by strategic investors with a consistent track record of responsible and long-term engagement with corporate strategy. Boards could choose to give investors that are sympathetic to the company's long-term objectives with more possibilities to engage or to be directly involved in the board.
- The diversity of the board could reflect the company's operational environment and its plans, taking into account factors such as age, experience, expertise, gender, nationality and qualifications.
- Board terms can be staggered with a reasonable recall provision for incoming directors, which the board, shareholders or other specified actors could trigger in the event of wrongdoing.
- To strengthen board appointment procedures, board members' qualifications and remuneration could be made public.

Section VI

Revise incentive structures

Summary

Incentive structures effectively determine objectives for corporate directors and managers. A significant part of top executive remuneration consists of variable pay, typically in the form of share options or incentive plans linked to share price. This practice has a number of undesired consequences. In particular, it motivates executives to divert corporate resources from investment to short-term strategies seeking to influence share price and thus away from long-term value creation to short-term value extraction. This hurts the long-term prospects of corporations and the interests of their stakeholders, including long-term oriented shareholders. One indication of this is exorbitant CEO and director pay that is disconnected from real performance.

Recommendations

The roundtables identified several strategies that corporations can use in their incentive structures to support long-term sustainable value creation:

- Ensure that incentive structure metrics are associated with a firm-specific long-term value creation strategy that integrates financial and non-financial objectives.
- Make executive remuneration, and specifically share-based remuneration, conditional on the achievement and sustainment of long-term goals, including long-term economic performance, fraud prevention and detection, ESG goals, R&D investment and employee satisfaction.
- Publicly disclose executive remuneration and its ratio to minimum and median salaries in the firm.
- Allow employees to express their view on executive compensation schemes.
- Cap executive pay by reference to average, median or minimum salary within the corporation.

These options may be supported by appropriate public policy.

Section VII

Stakeholders

Summary

Current corporate governance theory and prevailing practice largely ignore the interests of stakeholders other than shareholders, despite the critical importance of stakeholders to a corporation's long-term success. These stakeholders comprise internal stakeholders, like employees, but also external ones like creditors, suppliers, customers, society at large, and the environment.

A business strategy that profits at their expense may quickly undermine a corporation's social license. Moreover, as was mentioned in all the roundtables, the scale and complexity of social, environmental and economic challenges facing our societies require that businesses actively contribute to solving rather than causing them.

Recommendations

The roundtables identified the following options to facilitate corporations to engage stakeholders and/or reflect their interests in their governance:

- Specify fiduciary duties and liabilities for directors in corporate governance documents with respect to stakeholders' interests and clarify which audiences and matters are relevant for the corporation.
- Use a corporate form or governance arrangement that provides control or monitoring rights to stakeholders in order to safeguard a corporation's multi-stakeholder philosophy.
- Employ non-executive or executive directors to represent stakeholders or interests affected by the corporation and provide them with clear mandates, rights, and responsibilities, within the framework of their overall responsibility to the corporation.
- Provide employees with a right to express an opinion on the remuneration scheme of executive directors.
- Use stakeholder and materiality analysis as the basis for a corporation's reporting and embed it in the corporation's strategy-making processes.

Section VIII

Long-term and sustainable investment

Summary

Shareholders, in particular institutional investors, can substantially influence corporate strategies. Their engagement in corporate governance thus represents an opportunity to contribute to the corporation's sustainability and long-term value creation. The current corporate governance model expects institutional investors to fulfil this role, i.e., to provide effective oversight, engagement and the provision of a long-term vision on corporate governance. However, the increasing directedness of both retail and institutional shareholders toward market value combined with the engagement by explicitly short-term oriented institutional investors, such as activist hedge funds, exerts pressure on corporate boards to focus on short-term shareholder value.

This dynamic is supported by the threat of a market for corporate control and the use of incentive structures that reward both boards and executives who adopt short-term market value oriented strategies. For this reason, strengthening shareholders' rights without further qualification can reinforce the broader dynamic of a short-term oriented corporate governance system, instead of fostering systemic change.

Recommendations

To address these structural aspects and in order to foster 'patient capital' that works with corporations to create sustainable wealth for both retail and institutional shareholders, the roundtables identified several possible strategies that can be followed both by corporations and policy-makers:

- Allow and use multiple classes of shares to vest voting rights with committed shareholders.
- Allocate rights and incentives to investors on the basis of the length of shareholding or contribution to the corporation's capital, for example, by:
 - Setting voting rights in proportion to the time of presence in a firm's capital.
 - Providing the rewards of shares, e.g. dividends, on the basis of the time that the shares have been held.
 - Making votes conditional on the status of shares at purchase.

- Decreasing or exempting capital gains tax on the basis of long-term shareholdings.

The roundtables also identified the possibility for policy-makers to ensure greater transparency of investor involvement in investee corporations by requiring:

- Stricter notification of substantial holdings of investors and strategic direction of their engagement in investee corporations.

In the case of the market for corporate control, certain roundtable participants recommended that the (fiduciary) duty of the board to act in the best (long-term) interests of the corporation and its various stakeholders be interpreted as permitting the use of defensive measures against hostile takeovers.

Section IX

Corporate reporting

Summary

The way corporate activity is accounted for is crucial to shape the way investors and other stakeholders see and assess a corporation. The form of corporate reporting used creates powerful incentives for corporate boards to establish their targets and to decide the means to achieve those targets. The current accounting models and legislative framework focus primarily on short-term financial information and do not address several issues that are essential for a corporation's ability to create sustainable value. The legislative instruments that have been adopted so far to support extra-financial reporting have limited provision for monitoring or enforcement.

At the same time, investors are increasingly interested in the value creation process and there is an evident trend among successful corporations towards reporting on long-term value creation in relation to the interests of all key stakeholders. This is supported by research that shows that corporations with good ESG performance and reporting outperform their peers on the stock market in the long-term and benefit from lower cost of capital.

Recommendations

In this respect, the roundtables recommended corporations to consider the following best practices:

- Adopt the integrated reporting <IR> framework, allowing corporations to

meaningfully report on their value creation strategy, taking into account intangible assets and non-financial capitals.

- Identify and report on salient risks of adverse social and environmental impacts connected to the corporation's business, as well as due diligence systems set up to prevent, mitigate and remediate such risks and impacts, including their application.
- Specify unambiguous objectives for eliminating or mitigating these risks and impacts, and track their progress.
- Carry out and disclose an assessment of systemic risks and explain how the corporation's strategy reflects these risks, while focusing on long-term value creation.
- Describe the results of the materiality analysis reflecting the interests and needs of the corporation's key stakeholders, as well as their relevance to the corporation's strategy.
- Allocate responsibility for reporting on ESG matters to the CFO and mandate the oversight to a director.
- Reflect the corporation's long-term sustainable value goals in the management incentive scheme.
- Develop a materiality matrix to identify and measure the net positive impact value (NPIV) of strategic business decisions to shareholders, stakeholders and society-at-large and their alignment with the corporation's purpose and strategy for the creation of long-term sustainable value.
- Include within the board's responsibilities an assessment of principal ESG and systemic risks, the development of a strategy to fit within planetary boundaries and a statement on how the corporation meets its purpose, addresses both interests and meets the needs of key stakeholders.

Policy-makers can help to integrate social and environmental aspects in corporate reporting by implementing the following:

- Request that ESG information be included in annual reports;
- Provide clear indicators and methodology for specific matters, e.g. use of materials, greenhouse gas emissions, land use, and water use;
- Mandate reporting on long-term value creation strategy, taking into account non-financial capitals in the sense of the <IR> Framework; and
- Encourage or require independent verification (in the form of monitoring and

assurance) to help management substantiate that its internal processes and its reported information are credible and of investment-grade quality.

Conclusion

Building on the expertise of leading practitioners and academics in both the U.S. and Europe, the roundtables identified desired outcomes and key principles for a new model of corporate governance capable of achieving these objectives. Roundtable participants pointed to a diverse range of options for corporations, investors, and policy-makers as they looked for the most effective way to ensure that corporate governance contributes to a broad and long-term understanding of corporate purpose.

Many leading companies are already guided by these principles, thereby demonstrating that the approach is not only possible but that it can also give corporations a competitive edge leading to better economic performance as well as to better long-term results in capital markets. If implemented across all listed companies, this emerging approach to corporate governance could help corporations to align their strategies with the interests of society and take into account systemic risks such as climate change and growing inequality. The effect would be a renewed focus on creating long-term sustainable value, improved corporate resilience and a stronger social license.

While different options will be more appropriate in specific jurisdictions and for certain corporations, several issues stood out as generally accepted and of equal importance everywhere. In particular, the roundtables identified the need to broaden the purpose of the corporation, extend the scope of corporate strategy to include long-term goals, clarify the duties of directors, revise incentives and improve the way corporate performance and value creation are measured and accounted for.

The principal conclusions of the Purpose of the Corporation Project and the Corporate Governance for a Changing World Roundtable Series are that there is an emerging consensus that the goal of the corporation should be to create long-term sustainable value for customers and shareholders, while contributing to societal well-being and environmental sustainability; that these objectives can be mutually reinforcing; and that corporate governance should be developed to a standard where it may contribute to these objectives. This report identifies a number of possibilities to achieve this change.

