

May 2016



**BIG
INNOVATION
CENTRE**

The Purposeful Company
Interim Report

Steering Group

Birgitte Andersen, Big Innovation Centre
Clare Chapman, Kingfisher
Alex Edmans, London Business School
Andy Haldane, Bank of England
Will Hutton, Big Innovation Centre
Colin Mayer, Saïd Business School
Philippe Schneider, Independent
Consultant

Contributors

Sue Garrard, Unilever
Tom Gosling, PWC
Lu Liu, Bank of England
Colin Melvin, Hermes
Jennifer Nemeth, Bank of England
Will Pomroy, Hermes
Dominic Rossi, Fidelity
Matthew Willison, Bank of England
Allister Wilson, EY
Ruth Yeoman, Saïd Business School

Task Force

Nick Appleyard, Innovate UK
Richard Blakesley, Quantiplay
Mark Devereux, Olswang
Katherine Garrett-Cox, Alliance Trust
Herman Heyns, EY
Carsten Ingerslev, Danish Business Authority
Mohit Joshi, Infosys
Valerie Keller, EY Beacon Institute
Steven Lang, EY
Veronique Laury, Kingfisher
Roddy Macdonald, Scottish Government
Xavier Mamo, EDF Energy
Ruth McKernan, Innovate UK
Colin Melvin, Hermes Investment Management
David Pemsel, Guardian
Dominic Rossi, Fidelity
David Silke, Juniper Networks
Ashok Vaswani, Barclays
Ajay Vij, Infosys
Nigel Walker, Innovate UK

Media Inquiries: Please contact James Chandler at Red, 020 7025 6500

Launched in September 2011, Big Innovation Centre is a hub of innovative companies and organisations, thought leaders, universities and 'what works' open innovators. Together we test and realise our commercial and public-purpose ideas to promote company and national innovative capabilities in a non-competitive and neutral environment. We act as catalysts in co-shaping innovation and business model strategies that are both practical and intellectually grounded. Our vision is to help make the UK a Global Open Innovation and Investment Hub by 2025, and to build similar initiatives internationally. For further details, please visit www.biginnovationcentre.com

Foreword

Dear Reader,

The aim of this Interim Report is to mobilise people to make change happen in the UK. Specifically, it is to argue for better conditions to allow our companies to increase long-term value creation and thus Britain's growth and competitive advantage. It is an interim report, which we recognise is work in progress, before the publication of our final report in autumn 2016. So please both read the report and then respond to the call for evidence, with details set out on page 134.

We want to thank the Task Force who have guided and shaped the work so far and invite you to join us as we move on from marshalling the evidence to developing policy and good practice. One of the unique features of this movement for change is that there are representatives from all the key players in value generation ecosystem. Please choose to make the difference and respond to this report.

Thank you.

The Purposeful Company Steering Group

Executive Summary

Fast Summary

- Purpose is key to corporate and economic success. Great companies are enabled by the pursuit of clearly defined visionary corporate purposes, which set out how the company will better peoples' lives.
- British companies are inadequately organised around clear corporate purposes that unite all stakeholders in common goals and values. The economic costs of this are huge, potentially exceeding £130bn a year.
- Companies that operate in financial and ownership ecosystems that foster great company purposes are proven to innovate, invest, serve customers and engage employees better than those that do not.
- The British ecosystem militates against purposeful companies with its uniquely fragmented, diversified shareholder base, a particular legal and regulatory system that imposes short-term profit maximisation on company boards, and too few forces that counteract these tendencies.
- Financial markets systematically under-estimate the value of investments that purposeful companies make in the 'intangibles' of know-how, R&D and skills. This is an important reason for the rise in delistings and decline in initial public offerings, the crucial mechanisms through which the wider public shares in wealth generation.
- With the inexorable rise in intangibles in the 21st century, Britain risks becoming an economic backwater if it does not foster purposeful companies.
- The launch of this report marks the start of a major consultation on options for change. These encompass corporate law, corporate governance; executive remuneration; equity ownership; shareholder engagement; disclosure; accounting practice and taxation.

Report Summary: Introduction

- Great firms are precious economic and social organisations. They are the originators of wealth generation, offering solutions to human dilemmas and wants at scale, and are thus agents of human betterment. They are enabled by the pursuit of clearly defined visionary corporate purposes, which set out how the company will better peoples' lives. Those purposes are binding commitments on the whole of an

enterprise that generate trust and enable increasingly sophisticated forms of value creation.

- Those great firms are more important than ever in a knowledge rich economy. Investment in intangible 'knowledge' assets – ideas, brands, software, algorithms, patents, copyrights etc. – is now close to double that of investment in the tangible assets of machines and buildings.
- The UK has experienced a boom in corporate start-ups, but very few are scaling up to become great value generating companies. Meanwhile the stock of such value generating companies originated in Britain that have grown to possess strong market positions at home and abroad is too small and shrinking, with consequences for economic and social performance. The losses from neglecting purpose comfortably exceed £100 billion a year.
- Confidence in business has fallen in tandem with rising customer and societal expectations. An emphasis on purpose would help restore it.
- The British ecosystem needs redesigning around four elements pivotal to the delivery of corporate purpose: ownership, governance, the ecosystem in which firms operate and the business model the company chooses to operate. It would be better that business pre-emptively shapes what can and should be done by rallying behind a feasible reform programme rather than waiting for external, possibly ill-judged interventions, driven by impatience and anxiety for change.

1. Purpose – its meaning and why it matters

- **The purpose of a great company is its reason for being.** It defines its existence and contribution to society. It determines its goals and strategy. Underlying it is a set of values and beliefs that establish the way in which the company operates. Purpose is as fundamental to a corporation as our purposes, values and beliefs are to us as individuals.
- Purpose operates on four major planes – a covenant with customers, a reciprocal human contract with employees, mutuality of interest between society and firm and the desire to contribute to human betterment.
- In economists' terms a company is a network of contracts with everyone – owners, managers and workers – responding rationally to incentives that produce organisational and wider economic benefit. However, in practice contracts are incomplete, difficult to enforce and subject to default.
- It is through a strong corporate culture that stakeholders are encouraged to internalise the behaviours firms want to create and sustain. Purpose is the indispensable means to create such a corporate culture of integrity, crucial to business success.
- The table below sets out six categories in which a selection of companies have organized their purposes along with associated values. It is not exhaustive but rather demonstrates the range and character of what this report discusses.

Figure 1.1 Ways of Creating Meaning

Sub-type	Definition	Companies	Values	Dangers / Issues
Universalization	To allow everyone to experience what the few have	Google IKEA Kingfisher Tata Walmart	Fairness Equality	What do you do when you achieve your aim?
Innovation	To go where no one has gone before	ARM Holdings Illumina Samsung Tesla Motors	Pioneering spirit	How to keep innovation engine going while making discoveries
Fresh challenge	To challenge complacency and the 'big guys'	Ovo Energy Motif Investing Uber Under Armour	Underdog empathy	What happens when you become big yourself?
Excellence	To strive for perfection in one's art	Apple Bang & Olufsen BBC BMW HBO In-N-Out Burger	Achievement Drive	Does not inspire everyone because of narrowness
Global responsibility	To do business in a way that is sustainable and ethical	Centrica Nationwide Nestlé Statoil	Community spirit	People can question authenticity and realism
Human values	To do business in a way which recognises the humanity of employees, suppliers and customers	John Lewis Lush Southwest Airlines Starbucks Toyota	Human concern	Potential conflict with profitability

Source: Bains adapted

- Economic growth is closely associated with firms' "computational capacity" to confront complexity and creatively gather necessary information. It is unlikely that any one individual or organisation will possess the relevant knowledge or know-how to respond effectively to all business challenges – hence the role of trust in facilitating the process of opening up to others, which in turn, permits larger networks and more sophisticated forms of value creation.
- The pay-offs to purpose are increasingly measurable, reflected in superior share price performance, improved accounting and operational performance, more valuable innovation and lower cost of capital. They are also associated, among other things, with improved recruitment, retention and motivation of employees, less

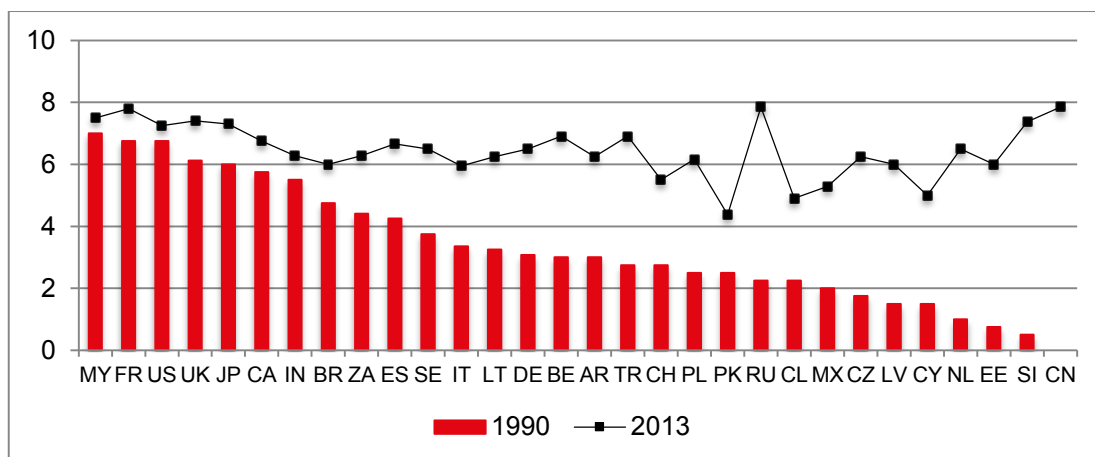
adversarial industrial relations, 'right-sizing' organisations and de-centralising decision-making, smaller regulatory fines and greater resilience in the face of external shocks.

- However, some dimensions of purpose are likely to matter more than others, depending on the industry in which companies operate. Choices also need to be aligned with companies' specific strategies and business models. Spending effort, time and money on issues that are not aligned to industry profile or business strategy are unlikely to contribute to financial performance and may even be counterproductive.
- To integrate purpose, firms need to demonstrate in concrete terms what purpose means to them – and how they can credibly commit to it particularly when under financial pressure.
- The achievement of purpose requires both committed leadership and widespread buy-in at every level of the firm. Techniques vary from promoting executives who have shown commitment to purpose, making public commitments, piloting experiments and signing up to international and national initiatives. Buy-in demands that there has to be alignment of deeds with words, which is also true of external communication. It is particularly challenging, but not impossible, to win over a critical mass of the company's shareholder base.

2. Shareholder rights

- Corporations were established as institutions with autonomous lives as self-standing legal entities independent of those who worked, financed and managed them. They were devices to ensure long-term commitment to shared goals and risks, with reciprocal obligations on those engaged in them.
- However as companies and economies have grown, companies have raised shares on public markets. This has led to the preoccupation with the so-called 'agency problem' in the modern corporation of aligning the interests of managers with those of their external shareholders to avoid unprofitable growth or undue complacency. The common response – see the figure below has been the strengthening of shareholder rights in every country – both to protect against either over-mighty shareholders or managements. The question is whether such increased rights go far enough in protecting not only the interests of minority shareholders but also those of the other parties who are critical to corporate success and also vulnerable to sectional interests.

Figure E2: Shareholder protection in thirty countries in 1990 and 2013



Source: The Law, Finance and Development Project (2015)

- There is a crucial distinction between the engaged owner shareholder and shareholder as short-term investor. Owners are involved in the oversight and sometimes the management of firms. They accept responsibilities as well as rights – responsibilities to ensure that the company delivers on its purpose and to bear at least some of the consequences for its failure to do so.
- Shareholders as investors provide capital, they earn returns from their investments, they receive reports on the performance of their investments and they sometimes cast votes at shareholder meetings. The purpose of the corporation from their perspective is to generate as large a financial return as possible with little consideration as to how it is done.
- At present the bias is insufficiently to recognise the role of the shareholder as engaged owner.
- The corporation should protect the interests of its minority investors but it also needs to be able to commit to and protect the interests of the other parties – creditors, employees, customers, suppliers and communities – involved in its corporate purpose. The corporation has lost the capacity to provide such commitments and been unbalanced by emphasising the interests of short-term shareholders over other parties, making purpose hard to achieve.
- One key function of the firm is to enable the implementation of ‘idiosyncratic ideas’. These are ideas based on visions of the founders and entrepreneurs that are difficult to communicate to outside investors. Placing control in their hands may threaten the adoption of visionary innovations that in the long-term are extremely valuable.
- Companies, ambitious to create value and sustain purpose, need devices to enable shareholder commitment. There is considerable debate about the effectiveness of such commitment devices including staggered boards, takeover protection mechanisms and dual shares – all more prevalent in the US compared to Britain. As with any complex human and commercial activity, there is a ledger of pluses and

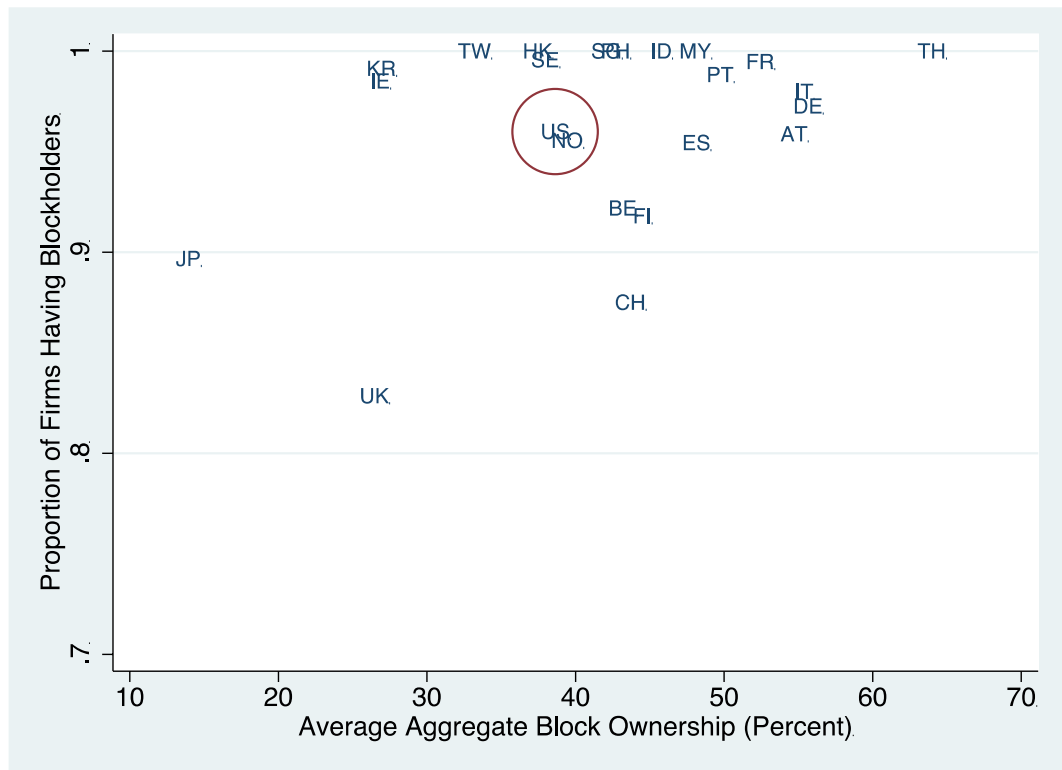
minuses and evidence that the net effect depends on the nature of and the context in which activities are being undertaken.

- But one thing is indisputable. Britain provides its companies with fewer such commitment devices than any other country in the world, including the US. For example, although the UK Takeover Code, while recently strengthening some protections against hostile takeover, does not match US protections. British founders and managers are not afforded the discretion the US confers on them to adopt what they regard as appropriate ownership structures. Limitations on dual class shares, staggered boards and anti-takeover devices are generally disallowed because they are felt to impede the expression of shareholder rights and interests.
- The UK has erred in seeking the uniform adoption of shareholder rights. Rather companies should have greater latitude in determining what is suited to their particular activities. Diversity should be welcomed and encouraged through regulation that is enabling and permissive rather than prescriptive and restrictive.

3. Ownership and Purpose

- British companies stand out internationally in that they have a very diversified, fragmented shareholder base. Most companies in the world, including in the US, have significant blockholders – UK companies have few.

Figure E3: Large-block common stock ownership at public corporations in the United States and 22 other countries



Source: Holderness (2009)

- Blockholders are able to act as anchor owners who lend stability to companies and their executives who are otherwise buffeted by short-term pressures.
- At the same time, blockholders have the interest and resources to gather costly information about the companies in which they invest. Blockholders promote corporate purpose and are associated with higher R&D expenditure, innovation and firm performance.
- Blockholding, however, is not a universal panacea. Right-sized, blockholders who are unaffiliated to the company have the best impact on culture and performance. Blockholding flourishes in a supportive legal, cultural and regulatory ecosystem. Diversification and disclosure requirements, stock market liquidity, founders' preferences, the availability of commitment devices and how shares are issued and placed can all contribute to the formation of effective blocks.
- Foreign ownership has increased significantly in most markets around the world, but in other countries has not disturbed block holding. For example in Germany the proportion of companies with dominant family owners controlling more than 25% of shares of the largest 200 non-financial companies has remained in excess of 30% over the last five years.
- There has been an explosion of intermediaries standing between the individual investor and final investments with accompanying information asymmetries, the rise

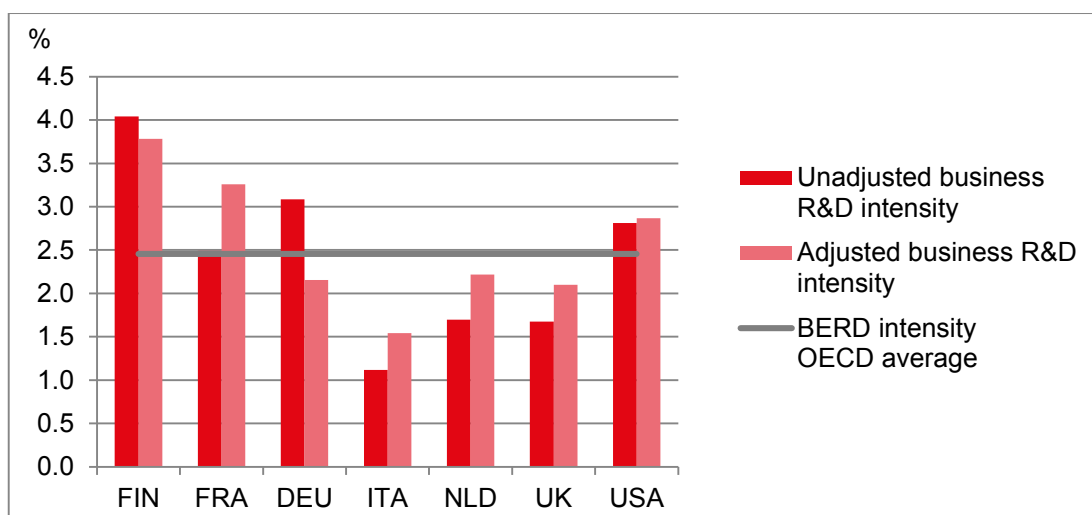
of passive investment strategies and fierce competition between asset managers based on relative performance – factors which have made it difficult to align decision-making with a long-term perspective.

- The proportion of equities held by traditional long term investing institutions such as corporate and public pension funds, and insurance companies has collapsed reflecting the impact of demographics and national and supranational regulation. Long term equity owners are more likely to support purpose over time. Asset managers are partly responding to the wishes of their savers and investors, along with a particular incentive structure. Too much of the industry is incentivised by short-term performance – and this, in turn, has a strong bearing on the extent to which managers churn their portfolios, an emphasis that is ultimately passed along to investee companies.
- Pension fund trustees often lack relevant experience and knowledge so they turn to external advisors. The UK also has many small – and even sub-scale schemes – that makes it more difficult to attract talent and manage investments in-house. Stewardship is not taken sufficiently seriously, notwithstanding initiatives like the Stewardship Code.
- Companies can help change investor focus by communicating a long-term strategy. There is evidence that firms with a short-term orientation attract investors with a similar preoccupation.
- Poorly designed executive incentives exacerbate the problem. Essentially executive reward, with cash bonuses and short term vesting periods for shares geared to the delivery of short term financial metrics, reward behaviours that preoccupy the shareholder as short term investor. Executive incentives should rather be aligned to the shareholder as owner, with longer term vesting periods, payment in debt as well as equity and metrics which emphasise the delivery of strategy and purpose.

4. Stock Markets, Investment and Productivity

- The UK's tangible capital investment record is a long-standing weakness; with investment levels as a share of GDP historically lower than those of France, Germany and Japan. However if intangible capital is included, the UK is less of a conspicuous outlier.
- Even adjusting for the structure of the UK economy with its heavy emphasis on services, investment in R&D – a key intangible – is below the OECD average (see chart below).

Figure E4: Business expenditure on R&D as percentage of value added (adjusted and unadjusted for sectoral composition of GDP), 2013



Source: Modified from OECD Main Science and Technology Indicators 2015 (Figure 5.1.1)

- Lack of awareness of the value of intangibles is pervasive in British business life: they are not part of executives' natural language while investors struggle to ask informed questions about them. Accounting and financial reporting standards have grappled with the task of reflecting the importance of intangibles but have been weighed down by numerous technical and definitional challenges.
- The payback from R&D can take decades, so that the impact of thirty years of underperformance, even allowing for recent stabilisation relative to pre-crisis levels, may help to explain the productivity problem confronting Britain today.
- There is significant evidence suggesting that the stock market is myopic and undervalues important intangible assets. This holds even when quality and success can be readily ascertained – whether it is a firm's R&D ability or its levels of employee satisfaction.
- Executive pay, quarterly disclosure of earnings, credit ratings and the stock market pressure to maintain dividends all reinforce short-term tendencies.
- The decline in the IPO market and the reluctance of firms to go public is seen as an offshoot of this; however, comparison with private firms suggest that it is *ownership concentration*, rather than a firm's public or private status *per se*, that creates these outcomes. Blockholders in public firms may be able to provide the benefits of concentrated ownership. Moreover public markets provide substantial other benefits that are not found in private ownership.
- Although there is debate about the degree companies pay either excessive dividends and/or excessively buy back their own shares, there may be some advantages to share buybacks as a flexible way of returning cash to shareholders without the stigma, when stopping or reducing the programme, associated with dividend cuts. However the key to investment is less firms' choices about how they

return money to shareholders but rather their capacity to sustain a purposeful, value-generating strategy over time and the degree to which they are pulled away from such strategies by a stock-market that misvalues their future earnings.

5. What is to be done?

- We have gathered together a range of policy options grouped under five headings. **They are options, not recommendations, on which the Taskforce invites comment over the next six weeks. We are not being directive at this stage.**
- **Option One: Business Implementation and Remuneration.** Companies should make purpose more salient in their corporate thinking, company statements, business practice and remuneration structures. Executive incentives should also be re-organised to incentivize managers to behave more as engaged purposeful owners than transient investors: in particular vesting periods for equity should be much longer term.
- **Option Two: Corporate Governance and Commitment Devices.** *Modified or hybrid* staggered boards and dual shares could be introduced along with strengthening the voice and power of stakeholder groups – whether through reform of Section 172 of the 2006 Companies Act or the establishment of new stakeholder panels. Benefit Corporations have pioneered a redefinition of fiduciary obligations, which could also be borrowed and extended into British corporate law. Restrictions could be considered on the rights of short-term shareholders during takeovers.
- **Option Three: Blockholding, Monitoring and Engagement.** Loyalty shares, improved information disclosure and safe-harboring large investors who in exchange for supporting purpose win access to privileged inside information could all enable more blockholding. Overhaul accounting standards and financial reporting to encompass the role of intangibles.
- **Option Four: Strengthen Capabilities of Asset Owners** Consolidation of pension funds would greatly improve the sector's capabilities. Pension fund trusteeship could be radically professionalised. Investments in an ISA wrapper should have a positive duty to promote corporate stewardship in return for the tax advantages they enjoy. Stewardship code to be strengthened along with tax incentives to encourage asset managers to sign up.
- **Option Five: Reverse Decline of British equity ownership** The equalisation of the tax treatment of debt and equity as the Mirrlees Review recommended would promote equity issuance. Employee stock ownership schemes could be enlarged by extending membership to a wider range of stakeholders who support the company purpose. Customer stock ownership plans (CuSOPs) would supplement ESOPs. A British sovereign wealth fund could be created to invest in purposed public and private companies.
- The evidence case for change is indisputable, but reform will require not only conviction that Britain cannot continue as it has – but the creation of as wide support as possible to support any proposed reform. We hope our consultation exercise will be a catalyst for winning such support and wider policy learning.

Introduction

Great firms are precious economic and social organisations. They are the origins of wealth generation, offering solutions to human dilemmas and wants at scale, so improving the human lot. They are agencies for human betterment. Successful organisations are those that can access, transfer and assemble knowledge, wherever it resides, to create increasingly sophisticated forms of value in a process of continual reinvention and innovation. Those great firms that can do this are never more important than in the knowledge rich economy of today. Investment in intangible 'knowledge' assets – ideas, patents, brands, software, copyrights etc. – is now close to double that of investment in the tangible assets of machines and buildings. Operating well in this environment is critical to both business and wider economic success.

This report has a simple underlying message. A strong domestically owned corporate sector that creates sustainable value in these terms is critical to the success of the UK economy. The UK economy has too few, and a rapidly diminishing, number of great domestic value-generating companies with strong market positions at home and abroad capable of exploiting the burgeoning opportunities of new technologies in the world where intangible assets dominate. This reflects itself in general economic and social underperformance, and growing concern that matters are getting worse. Performance needs to improve both for business and society. Thus the importance of our analysis that central to the success of companies is the pursuit of clearly defined visionary corporate purposes. Those purposes are not just rhetoric – they are binding commitments on the whole of an enterprise from the board of directors to the shop floor that generate trust. It is trust on which relationships and transactions in advanced as well as developing economies depend, not contracts and markets.

There are four elements pivotal to the delivery of corporate purposes and the building of public trust: ownership, governance, the ecosystem in which firms operate and the business model the company chooses to operate. In the UK these do not interlock to promote purpose, and the British corporate sector is the poorer for it. It is true that business has made a huge contribution to reducing global poverty and improving life expectancy in the past two hundred years. But too many people are still left behind and public trust in the firm is declining due to some baleful corporate behaviour over the past three decades.¹ Putting this right is not difficult and requires reforms well within the bounds of feasibility. If achieved these reforms will pave the way to a stronger and more vibrant corporate sector whose benefits would be more widely shared. This mission will also require more corporations to exercise responsible behaviour and exert greater self-control to win back more legitimacy to

¹ Greve, H., Palmer, D. and Ponzer, J. (2010) 'Organizations Gone Wild: The Causes, Processes, and Consequences of Organizational Misconduct', *The Academy of Management Annals* 4, 53–107.

operate.

There are areas of strength. The UK business services sector has performed strongly over the last two decades amid a wider surge of business start-ups. Over the 36 years from 1980 to this year the number of domestically incorporated companies in the UK has increased from 785,000 to 3,464,000 – a more than four-fold increase. Over the last few years alone the number of incorporated companies has increased by 773,000.² At one level, the UK corporate sector is thriving; however, at another it is not.

The contrast with 50 years ago is telling. Then the UK had the leading companies in the world in chemicals, electrical engineering and electronics, to name just a few sectors – iconic names like GEC, ICI, Marconi and Plessey that were global leaders but were then merged, taken over or went bankrupt. There is not an emergent new generation of great companies ready to take the place of these former champions. Only two high tech companies – ARM and SAGE – represent the new technologies in the FTSE 100. This compares poorly with the aftermath of the 1930s recession, when a range of companies emerged in aerospace, chemicals, automobiles, and electronics. Investor Neil Woodford observes that Britain is not doing enough to turn its great scientific and university base into great businesses, in particular committing long term patient capital; as a result Britain is failing as an economy to seize the opportunities before it.

Associated with the disappearance of domestic large companies has been an inflow of foreign capital to acquire UK companies. Since the beginning of this century the value of foreign acquisitions of UK companies has been approximately twice that of domestic UK acquisitions.³ This has brought welcome foreign capital, including engaged and long-term owners, along with managerial expertise into the UK and has exposed British firms to the discipline of the takeover market. But this benign view neglects significant downsides. There is a question of degree. The transfer of ownership of large UK corporations overseas to such a large extent matters because the domicile of corporations is influential in their decisions about employment, investment, R&D and the wider public interest – so-called home bias.⁴ There is evidence that multinationals display such a home bias in many of their decisions, as Kraft has done in its takeover of Cadbury. The task is to balance the advantages of inward investment and foreign ownership while guarding against the process being taken to excess.

This relates to the second issue: the decline in public trust in business, as reported by Gallup and other opinion surveys.⁵ The outgoing director general of the CBI, John Cridland, said the trust deficit may take a generation to close. Business needs societal confidence both in terms of its wider licence to operate and the increasing public role it is being asked to play. Trust is the key ingredient that makes for successful business. Economics has regarded

² UK Companies House (2015) *Statistical Release*.

³ Office for National Statistics (2015) *Mergers and Acquisitions involving UK Companies*.

⁴ See, for example, Higson, C. (2014) 'Measuring the Public Interest in Foreign Acquisitions'; Working Paper. 88% of the CEOs of the global top 500 are nationals of where their company is headquartered.

⁵ Gallup polling in the US shows a consistent fall-away in public faith in big business – a trend mirrored in Britain.

contracts and markets as the sole necessary instruments to cement relations between different parties but there is an increasing realisation that this is wrong. Most relationships and transactions need more than simple market contracts to underpin them; they need trust and it is institutions, in particular corporations, that can create the values and environment in which trust is generated.⁶

Enter corporate purpose. This is the firm's statement of what it stands for and what it should be trusted for. If the firm cannot lend credibility to its purpose, it is as much without form or substance as we as individuals are if our word cannot be trusted. The essence of the corporation depends on its ability to be able to deliver on purpose without doubt or question.

That is where the ecosystem – the law, regulation, corporate governance, taxation – is of fundamental importance and potentially dysfunctional in the UK. It is becoming apparent that in many respects the ecosystem in which British business operates is an outlier. The way British companies are owned, financed and governed is atypical even by North American let alone Continental European and Asian benchmarks. In short the British ecosystem needs redesigning to permit enterprise to re-orient itself to value generation. Some of the necessary change can come from more self-aware boards doing more to create conditions that support this, but some will need a more generalised response. It would be better that business pre-emptively shapes what can and should be done by rallying behind a feasible reform programme rather than waiting for external, possibly ill-judged interventions, driven by impatience and anxiety for change. This report should be read in that context.

The Purposeful Company's Taskforce proposition is that it is purposefulness which binds great companies together, but that it has become much harder to express it in British business over the last generation with serious consequences for value generation. Creating circumstances in which purposefulness can flourish is a necessary if insufficient pre-condition for a British business renaissance.

⁶ See Mayer, C. (2013) 'Firm Commitment: Why the Corporation is Failing Us and How to Restore Trust in It'; Oxford University Press.

Table of contents

Foreword	3
Executive Summary	4
1. Purpose – its meaning and why it matters	19
What is purpose?	19
Purpose, culture and performance	23
Embedding purpose	34
Complementarity in operating models and sustainability practices	34
Leadership and managing change	36
The importance of external communication	38
Conclusion	41
2. Rights and wrongs	42
Shareholder rights.....	42
The right balance	44
Corporate culture	47
Implementing entrepreneurs’ vision.....	50
The capability to commit	50
British particularities	55
Conclusion	58
3. Ownership and purpose	60
Barriers to blockholding.....	67
British ownership structures compared	69
The UK asset management industry	74
The role of asset owners	79
Companies can help themselves	80
Executive incentives	81
Conclusion	88
4. Stock markets, investment and productivity	90

UK investment in tangible and intangible assets – is it below par?	90
Intangibles in the UK.....	95
Productivity	99
Is the stock market myopic?.....	102
Do dividends and share buybacks cause underinvestment?	110
Conclusion	117
5. What is to be done?	119
Policy options and background	121
The Purposeful Company – Call for Evidence	134
Submissions	134
Generating policy recommendations	134
Confidentiality	135
Acknowledgements.....	136
Contact details	139

1. Purpose – its meaning and why it matters

This chapter will describe what is meant by purpose and its role in establishing relationships that lie at the heart of successful corporations. It will discuss its link to the culture of organisations – the seedbed of trust and the resolution of the deficiencies of contracts and incentives – and it will describe the extensive evidence on the relation of purpose to performance in all its various forms. We also summarise the emerging learnings on embedding purpose from leading companies.

What is purpose?

The purpose of a great company is its reason for being.⁷ It defines its existence and contribution to society. It determines its goals and strategy. Underlying it is a set of values and beliefs that establish the way in which the company operates. Purpose is as fundamental to a corporation as our purposes, values and beliefs are to us as individuals.

This purpose must be sufficiently compelling and inspiring to invigorate all members of the company community. Every stakeholder in the enterprise must be convinced that everyone's interests are served in the necessarily complex trade-offs, fair balancing of rewards and investments that constitute the value generation process in which they have to make compromises and contributions.⁸ This requires the glue of trust and shared mission achieved by a sense of purposefulness. There is a shared belief that if the firm is not involved in a moral mission, then at the very least is doing its best to contribute to creating value for all.⁹ It is this capacity to create purpose and ensure as far as possible it is shared throughout the organisation that is the basis of a great firm, creating the sense of common cause without which it is impossible to hold the firm together.

Just as our purpose as individuals is dependent on the variety of interactions we have with others, so too the purpose of the corporation is a reflection of its various interrelations. There are four that have been commonly identified, supported by a growing body of evidence. The first is *external* and relates to what we conventionally associate with the purpose of a company: to serve its customers. The primary purpose of a company is necessarily to provide its customers with what they desire, need and expect and so provide proper returns that sustain the business and reward investors. The firm that promises quality and competence as part of its purpose creates a covenant with its customers; they in turn reciprocate with loyalty. Instead of a transactional source of revenue the consumer becomes a stakeholder – and this

⁷ The etymological definition of purpose is "intention, aim, goal."

⁸ See Freeman, E., Harrison, J., Wicks, A., Parmar, B. and De Colle, S. (2010) 'Stakeholder Theory: The State of the Art'; Cambridge University Press for a discussion of what the relationships between the various stakeholders look like, and who may be considered to be a stakeholder, a question which is highly contested.

⁹ Donaldson, T. and Walsh, J. (2015) 'Towards a theory of business', *Research in Organisational Behaviour*. 35, 181–207.

promotes trust, good faith and fair dealing. It also delivers more product innovation and reputation for quality, so improving brand and boosting sales. This goes beyond the obvious injunction to 'know your customer': it is to serve the customer as a purpose rather than oneself.¹⁰

The second aspect of purpose is *internal*, relating to employees. Relations between employee and the firm go beyond the explicit contract of pay and economic conditions of employment. In any human organisation there is necessarily an implicit reciprocal human contract, engaging workforces emotionally and intellectually – winning their loyalty and even dedication – but reciprocally offering scope for personal and professional growth.¹¹ This opens the door to cooperation, participation and team behaviour, which are as important to the firm as individual pay and possibilities for individual promotion. The more a company is organisationally healthy, getting these implicit contracts right – especially in the context of knowledge based firms where intellectual contributions need to be freely given – the better it will perform. It is a sense of purpose that drives such relationships. Value is created from shared purpose.

The third component of purpose is *societal* – the recognition that communities and companies have a mutuality of interest. Strong communities, a sustainable environment and avenues of accountability for firm behaviour benefit both firms and the wider society. It is firms with purpose that are readier to understand these points and implement appropriate policies. There is substantial evidence, cited later, that those firms that embrace best environmental, social and corporate governance practice also tend to perform better. Again the precondition is purpose.

This segues to the final element: the *moral* purpose of corporations. Purpose can be viewed as serving different constituencies – customers, employees, investors and society – but there is a further dynamising, almost existential, component to make purpose live: it is to contribute to the betterment of the world in which we live.¹² This most obviously touches on the wellbeing of future as well as current generations and the preservation and enhancement of nature and the environment, as well as individuals. More generally, it embraces the notion of going beyond *being* to *becoming*.

"Purpose clearly expresses the values and core beliefs of the members of the organisation. It incorporates the essential elements of a mission statement, a corporate credo as an expression of a code of ethics, and the vision of the organisation's future. Therefore, it must take into account the expectations of the organisation's internal and external stakeholders, the moral and ethical stance of the business, and

¹⁰ Anderson, E. (2015) 'The Business Enterprise as an Ethical Agent' in Rangan, S. ed. *Performance and Progress Essays on Capitalism, Business, and Society 185–202*; Oxford University Press.

¹¹ There is a very large literature on the above. Some of the relevant references are Hollensbe, E. et al. (2014) 'Organizations with Purpose', *Academy of Management Journal* 57, 1227–34; Kern, R. (1919) 'The Supervision of the Social Order', *American Journal of Sociology* 24, 423–53; Simon, H. (1964) 'On the Concept of Organizational Goal', *Administrative Science Quarterly* 9, 1–22; Bartlett, C. and Ghoshal, S. (1994) 'Changing the Role of Top Management: Beyond Strategy to Purpose', *Harvard Business Review* 72, 79–88; Hammond, 'Why Is the Intelligence Community So Difficult To Redesign'; Ready, D. and Truelove, E. (2011) 'The Power of Collective Ambition', *Harvard Business Review* 22, 17–23; Henderson, R. and Van Den Steen, E. (2015) 'Why Do Firms Have 'Purpose'? The Firm's Role as a Carrier of Identity and Reputation', *American Economic Review* 105, 326–30; and Hamel, B. et al. (2009) 'Moon Shots for Management', *Harvard Business Review* 2, 91–98.

¹² "A common English translation of the Greek word telos (τέλος) used by Aristotle to label something's "final cause"—"that for the sake of which" it exists (Metaphysics: V,2; Physics: II,3). Aristotle argued that a being tends (or ought to tend) toward its telos.

the values, beliefs, and norms of the organisation's culture."¹³

As the organisational theorist and strategist, Sumantra Ghoshal, and his colleagues wrote:

"Modern societies are not market economies; they are organisational economies in which companies are the chief actors in creating value and advancing economic progress.[...] That is, most of [the societies'] value is created not by individuals transacting individually in the market, as in the economists' ideal, but by organisations involving people acting collectively, with their motives empowered and their actions coordinated by their companies' purpose.

*In an organisational economy in which the essence of the company is value creation, the corporate and society are no longer in conflict. They are interdependent, and the starting point is a new moral contract between them."*¹⁴

Consultant and corporate psychologist Gurnek Bains in his book 'Meaningful Inc' has attempted a categorisation of purpose, and then organised the results in a hierarchy of effectiveness.¹⁵ Bains identifies three types of purpose statement, which he categorises as metrics based, existence rationale and invigorating. The first defines the company's purpose in terms of targets for, say, growth, profitability or market share. Bains argues that while such metrics can be useful in creating business focus, they inspire nobody, however important those metrics may be to the board. They fall short of a compelling purpose. Purpose statements need to embody big bold ambitions, categorised in the accompanying Figure 1.1.

Figure 1.1: Ways of Creating Meaning

Sub-type	Definition	Companies	Values	Dangers / Issues
Universalization	To allow everyone to experience what the few have	Google IKEA Kingfisher Tata Walmart	Fairness Equality	What do you do when you achieve your aim?
Innovation	To go where no one has gone before	ARM Holdings Illumina Samsung Tesla Motors	Pioneering spirit	How to keep innovation engine going while making discoveries
Fresh challenge	To challenge complacency and the 'big guys'	Ovo Energy Motif Investing Uber Under Armour	Underdog empathy	What happens when you become big yourself?

¹³ Pascarella, P. and Frohman, M. (1989) 'The Purpose-Driven Organization: Unleashing the Power of Direction and Commitment' 839; Jossey-Bass.

¹⁴ Ghoshal, S., Bartlett, C. and Moran, P. (1999) 'A New Manifesto for Management', *Sloan Management Review* 40, 9–20.

¹⁵ Bains, G. (2007) 'Meaning Inc: The blueprint for business success in the 21st century'; Profile Books.

Excellence	To strive for perfection in one's art	Apple Bang & Olufsen BBC BMW HBO In-N-Out Burger	Achievement Drive	Does not inspire everyone because of narrowness
Global responsibility	To do business in a way that is sustainable and ethical	Centrica Nationwide Nestlé Statoil	Community spirit	People can question authenticity and realism
Human values	To do business in a way which recognises the humanity of employees, suppliers and customers	John Lewis Lush Southwest Airlines Starbucks Toyota	Human concern	Potential conflict with profitability

Source: Bains adapted

A company, can for example, state that its purpose is to work for the universal good – in his terms democratising access and widening consumption beyond the very well-off so that Walmart qualifies as purposed. Google, IKEA, Kingfisher, Tata and Uniqlo in their particular ways make such claims – Tata wanting the underprivileged of the world to enjoy what the privileged enjoy, IKEA and Kingfisher to help millions of people to improve their homes, Google, at least in its early incarnation, to benefit from searching the web freely and Uniqlo's combination of low-cost clothing with high-fashion sensibility.

Innovation is another compelling clarion call; the company wants to go where no company has gone before. Other purpose declaration categories include doing the core business in a responsible way or treating stakeholders, including one's workforce with integrity and authenticity or taking on the 'big boys' and challenging the complacency of incumbents. If none of these options are open, then the purpose card to play is to commit to excellence – to celebrate raising the craft of a company and offering to its highest possible level.

Purposefulness thus expressed operates on a number of planes. It creates the social capital that underwrites the creation of functioning teams, employee participation and engagement – the precondition for achieving any targeted operating metrics. It operates externally as a means of generating customer and service focus. It operates as a social narrative, in communities and societies beyond the firm, helping to create and sustain a licence to operate. Finally it attempts to lift purpose onto a higher ethical plane. Purposed firms are committed to achieving goals that one way or another are aimed at human betterment.

Purpose, culture and performance

Purpose, values and trust are uneasy concepts for economists. In economists' terms a company is a network of contracts with everyone – owners, managers and workers – responding rationally to incentives that produce organisational and wider economic benefit. Economists have modelled economic behaviour on the basis that all parties to a firm will be incentivised by price signals, fear of the costs of failure and hoped-for reward. However, in practice contracts are incomplete, difficult to enforce and subject to default which economics has begun to concede. The firm, for example, may declare it is dedicated to customer service, but for any individual worker there is always the temptation not to go the last half mile and cheat on this commitment. One recent study showed how continual experimenting by workers in a steel mill accounted for two thirds of the doubled productivity over a twelve year period – a commitment that cannot be induced or enforced by workplace contracts. It is shared purpose that delivers such results.¹⁶

Nor does everyone have the same time horizons or same interest in a good outcome. There are short-term advantages to directors and managers not keeping their promises to their workers, or disguising the truth of matters to their shareholders. The real world universe is one of incomplete contracts and the costs and problems in policing them. Networks of market transactions are therefore both expensive and inefficient.

A strong corporate culture is the solution to the problem of incomplete contracts and imperfect incentives. It is through a strong corporate culture that stakeholders are encouraged to internalise the behaviours firms want to create and sustain – and the culture will necessarily possess integrity both in itself and its implementation. Purpose is the indispensable means to create such a corporate culture of integrity – crucial to business success, as anyone who works in or leads a business will testify. Trust cannot be achieved by asserting rules and protocols. Trust is created by multiple social interactions that reinforce behaviours and values and thus self-polices.

This is even more important in an age of multiplying unknowns where successful innovation requires ever more openness and porosity.¹⁷ Successful economies and firms can best be visualised as coalitions of capabilities bringing together the vast quantities of knowledge that would otherwise be scattered in a way that is less than optimal. The economist Cesar Hidalgo argues that it is computational power to organise information that drives all forms of growth; single individuals can only have computational 'person-bytes' of an individual.¹⁸ What organisations do at their best is to enable these person-bytes to be better marshalled. A modern car, for example, has 30,000 parts: what a successful car company does today is to marshal the vast international network that contributes each of these parts to the whole.¹⁹ It is a form of computation. However such leveraging and transfer of knowledge is facilitated by high trust, which

¹⁶ Hendel, I. and Spiegel, Y. (2014) 'Small Steps for Workers, a Giant Leap for Productivity', *American Economic Journal: Applied Economics* 6, 73–90.

¹⁷ Jones, B. (2009) 'The Burden of Knowledge and the 'Death of the Renaissance Man': Is Innovation Getting Harder?' *Review of Economic Studies*, 76, 283–317.

¹⁸ Hidalgo, C. (2015) *Why Information Grows: The Evolution of Order, from Atoms to Economies*; Penguin Press.

¹⁹ Bartelme, D, and Y Gorodnichenko (2015), 'Linkages and Economic Development'; *NBER Working Paper No. 21251*.

permits larger networks to work effectively, while low trust systems are characterised by rules and hierarchies, depending more on central authorities to spread knowledge.

It is no accident that so many of the highly successful west coast IT and tech companies are strongly purposeful: it is the precondition for building teams and alliances that marshal what would otherwise be scattered knowledge in an ever mutating and changing technological landscape. Amazon's CEO and Founder, Jeff Bezos, in his 2016 annual letter to shareholders celebrates Amazon's corporate culture notwithstanding the criticisms about stress and bullying, in particular the commitment to the "inseparable twins of invention and failure", the tolerance of failure but the accompanying successes and how it has become an energising magnet for like-minded people committed to such experimentation.²⁰ Importantly he includes his 1997 letter to shareholders to remind them of the continuity of his long term vision: his declared aims were the same then, and has produced the pay-offs – from the Kindle e-reader through Amazon Prime to its cloud service- that have led to Amazon's growth, in particular not obsessing about the short term share price.²¹ "We all know that if you swing for the fences," Bezos writes "you're going to strike out a lot, but you're also going to hit some home runs. The difference between baseball and business, however, is that baseball has a truncated outcome distribution. When you swing, no matter how well you connect with the ball, the most runs you can get is four. In business, every once in a while, when you step up to the plate, you can score 1,000 runs. This long-tailed distribution of returns is why it's important to be bold. Big winners pay for so many experiments". Bezos has his critics, but equally Amazon's growth and ambition are for all to see. It is the expression of consistent purpose over time.

Purpose in these terms is a source of competitive differentiation, an argument made forcibly by Rosabeth Kantor in her book *SuperCorp*.²² 'Vanguard' companies that ground their strategy with a view to promoting wider societal purpose have a compass for their strategy that competitors cannot readily emulate: if they genuinely care, for example, about their supply chain or how their products are disposed of once used they build connections, opportunities for innovation and loyalties not available to others. Companies become institutions that have meaning beyond the current bundle of assets or lines of business. Values and principles help vanguard companies avoid 'short-termism' and make choices with an eye on the future. She writes: "Management is temporary; returns are cyclical," IBM CEO Sam Palmisano said, explaining to me why he puts so much emphasis on values and culture. IBM is the sole survivor among the other major computer companies prominent in 1975; it has entered and exited businesses, but it is recognisably the same institution." She echoes Bezos' comments: purpose animates people and drives innovative performance.

This positive link between purpose and performance is supported by a growing body of micro-economic evidence. Some studies point to the benefits that accrue from individual dimensions of purpose such as employee engagement, customer satisfaction, supplier linkages and environmental stewardship. Other

²⁰ The full letter is available here:

<http://www.sec.gov/Archives/edgar/data/1018724/000119312516530910/d168744dex991.htm>

²¹ See Jones, A. 'The Riff: Jeff Bezos and Long-termism', *Financial Times*, December 30, 2015; Stewart, J. 'Amazon Says Long Term and Means It', *The New York Times*, December 16, 2011.

²² Kanter, R. (2013) 'SuperCorp: How Vanguard Companies Create Innovation, Profits, Growth and Social Good'; Profile Books.

studies find similar results for factors such as sustainability: it is only possible to achieve sustainability if that is translated into organisational behaviour that succeeds commercially – a task that requires the bond of purpose. Sustainability suffers from being over-identified with the green agenda, but it has another crucial dimension: it is how a firm can endure and reinvent itself competitively over time, particularly important in a world of fleeting business advantage. This cannot be done without excellent management, a commitment to purpose and developing other capabilities to execute the strategies that promote the firm's longevity. Framed in this way, the evidence on sustainability should not just be understood as a niche concern, but rather as directly relevant to mainstream business.

The pay-offs to purpose are increasingly measurable, reflected in superior share price performance, improved accounting and operational performance, more valuable innovation and lower cost of capital. They are also associated, among other things, with improved recruitment, retention and motivation of employees, less adversarial industrial relations, larger firm size and decentralisation, smaller regulatory fines and greater resilience in the face of external shocks.

Identifying a causal effect of purpose on performance is difficult due to two key challenges. The first is that correlation does not imply causation – performance may drive purpose as much as purpose drives performance. The second is that omitted variables such as firm and industry characteristics may jointly drive both purpose and performance. However, many recent studies have used techniques to address the identification challenge and demonstrate causal relationships.

We have systematically reviewed the literature at the forefront of these efforts – see the table that follows – setting out the problem investigated by the authors, their methodology and main findings. Together these studies go some way to reconciling conflicting findings in previous work – even while cautioning against one-size-fits-all conclusions. Cumulatively, they offer impressive empirical support – even allowing for qualifications and unanswered questions – for the proposition that purposefulness has beneficial effects across the spectrum of business outcomes. If applied across British business the suggestive performance improvement could be worth up to 6 to 7% a year, or up to £130 billion a year in increased stock market capitalisation. The next step in the chapter is to assess how well those firms minded to implement purpose succeed in so doing.

Figure 1.2: Academic evidence on the impact of purpose on performance

Study	Overview	Method/Controls	Findings/Commentary
Derwall et al. (2005) ²³	<p>Examines the relationship eco-efficiency and stock returns over the period 1995–2003. Eco-efficiency measures the value a company creates relative to the waste it generates using data from Innovest Strategic Value Advisors. Two mutually exclusive portfolios of US companies rated highest (lowest) by eco-efficiency are compared, each covering 30% of total market capitalisation of the NYSE-AMEX-Nasdaq Universe.</p>	<p>Basic controls for market risk, value, momentum and size anomalies and industry bias. Results are robust to different portfolio weighting methodologies</p>	<ul style="list-style-type: none"> • The performance differential between the high-ranked portfolio and low-ranked portfolio is 5.06% per annum, though it narrows considerably on an equal-weighted basis. • Raising the cut-off values of the portfolios to 20% of total market capitalisation, thereby widening the gap in environmental performance between the portfolios increases the differential to 8.2%. • Outperformance is not changed when using a 'best-in-class' approach and introducing transaction costs.
Fornell, Mithas, Morgeson III and Krishnan (2006) ²⁴	<p>Investigates the relationship between customer satisfaction, market value and stock returns (1997–2003). Customer satisfaction is measured by quarterly news releases from the American Customer Satisfaction Index (ACSI). An event study (161 events for 89 companies) is carried out to assess market reaction to ACSI news and two portfolios, composed of firms ranked in the top 20% of the ACSI over the period are tested for their potential to generate abnormal returns.</p>	<p>Basic controls for market risk, size and book-to-market ratio and firm-related news items for the event study.</p>	<ul style="list-style-type: none"> • There is no significant stock market reaction to the release of the ACSI, even though it is highly public. • Over the period, firms ranked in the top 20% of the American Customer Satisfaction Index outperform the Dow Jones Industrial Average by 93%, the S&P 500 by 201%, and NASDAQ by 335%. • Returns are achieved with much less risk than market e.g. the mean beta associated with the portfolio is 0.78. • Tentative evidence suggests that the market rewards high customer satisfaction more than it punishes low satisfaction. • Findings are suggestive since past shows that companies particularly struggle with defining appropriate metrics for consumer satisfaction.

²³ Derwall, J., Guenster, N., Bauer, R. and Koedijk, K. (2005) 'The Eco-Efficiency Premium Puzzle', *Financial Analysts Journal* 61, 51–63.

²⁴ Fornell, C., Mithas, S., Morgeson III, F. and Krishnan, M. (2006) 'Customer satisfaction and stock prices: High returns, Low Risk', *Journal of Marketing* 70, 3–14.

<p>El Ghoul, Guedhami, Kwok and Mishra (2011)²⁵</p>	<p>Assesses the effect of corporate social responsibility (CSR) on the cost of equity capital for a large sample of US firms (n= 2,809) over the period 1992–2007. It uses several implied cost of capital models which are increasingly common in accounting and finance research and viewed as an advance on traditional pricing models.</p>	<p>Controls for industry and year fixed effects and firm-specific determinants, including corporate governance and financial constraints. Results are robust to analyst forecast characteristics, including noise in forecasts (e.g. analyst over-optimism and sluggishness). Various approaches are explored to address endogeneity, including instrumental variables and the use of risk premium as a lagged independent variable, though the validity of the identification strategy is not specified and some of the tests are untabulated.</p>	<ul style="list-style-type: none"> • A one-standard deviation increase in CSR leads firms' equity premium to fall, on average, by 10 basis points. • Firms related to the tobacco and nuclear power industries have higher equity financing costs. • Characteristics that influence equity pricing are employee relations, environmental performance, and product features; all other characteristics exhibit little or no significant impact on firms' cost of equity. • Further work is necessary to see whether findings generalise to other forms of financing such as corporate debt pricing. Evidence on private debt financing, for instance, is more mixed.
<p>Edmans (2011, 2012)²⁶</p>	<p>Examines the relationship between employee satisfaction and long-run stock returns over the period 1984–2011, including the aftermath of the 2008 financial crisis. It is based on a sample of 245 unique public firms that feature in Fortune's 100 Best Companies (BC) to Work For In America list. A portfolio of BCs is constructed and reformed or rebalanced each time the list is updated. The Best Companies list was first published in 1984, then again in 1993 and each year from 1998. It is compiled by the Great Place to Work Institute which randomly surveys 250 employees at all levels on multiple dimensions of job satisfaction, as reported by employees (i.e. credibility, respect, fairness, pride, and camaraderie), as well as interviewing management on actual practices (e.g. turnover, compensation, benefits, diversity, time off and work–family issues).</p>	<p>The paper links employee satisfaction to future stock returns, to address reverse causality. If it were profits that caused satisfaction, then these profits would mean that the stock price would already be high today, and so future stock returns should be no higher. Thus, a link between employee satisfaction and future stock returns suggests that the former causes the latter. Controls are used for risk, industry performance and various firm characteristics e.g. dividend yield and trading volume. Results are robust to different portfolio weighting methodologies and the removal of outliers.</p>	<ul style="list-style-type: none"> • Companies listed in the 100 Best Companies to Work For in America generate significant returns over all benchmarks, ranging from 2.3% (controlling for industries) to 3.8% (controlling for market performance and other risk factors). • The market takes a very long time to incorporate information into the stock price: full incorporation can take as long as four to five years, even though the BC list is highly visible and on large firms that are widely followed. • Professional stock analysts systematically underestimate the earnings of the BCs – they consistently deliver earnings that beat analyst expectations. This provides further evidence that the superior returns to the BCs stem from mispricing, rather than an omitted risk • Employee satisfaction matters to firm value across the distribution, not just star performers on the BC list. Even firms that drop off the list and presumably still enjoy above-average satisfaction levels, slightly outperform their peers. • A number of alternative explanations are ruled out. One popular hypothesis is that superior returns are simply a result of socially responsible funds buying firms after they are included on a BC list, but this can only explain 0.02%/year.

²⁵ El Ghoul, S., Guedhami, O., Kwok, C. and Mishra, D. (2011) 'Does Corporate Social Responsibility Affect the Cost of Capital?', *Journal of Banking & Finance* 35, 2388–2406.

²⁶ Edmans, A. (2011) 'Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices', *Journal of Financial Economics* 101, 621–640; Edmans, A. (2012) 'The Link between Job Satisfaction and Firm Value, with Implications for Corporate Social Responsibility', *Academy of Management Perspectives* 26, 1–19.

<p>Bloom, Sadun and Van Reenan (2012)²⁷</p>	<p>Explores the role played by trust in firm organisation – in particular, in decentralising investment, hiring, production and sales decisions. Data are collected on roughly 4000 firms across 12 countries in Europe, North America and Asia through the design and use of a novel survey tool. The database on organisational practices is matched with the level of trust where the firms are located, using regional information from the World Values Survey.</p>	<p>To identify the causal effect of trust, the study examines multinational firms and levels of bilateral trust between the multinational’s country of origin and the subsidiary’s country of location. It instruments trust by using religious similarities between countries which are largely exogenous to the firm given that they are driven by very long-term historical factors. Results survive the inclusion of a large battery of controls that might increase decentralisation, including quality of law enforcement and management practices, levels of economic development and product market competition, geographical characteristics, industry affiliation, firm size and employee skills.</p>	<ul style="list-style-type: none"> • Trust is positively and significantly associated with greater decentralisation and firm size. For instance, a one standard deviation increase in trust is associated with a roughly 30% increase in firm size. • This relationship improves performance in a number of ways: unlike low-trust settings, CEOs are more willing to delegate decision-making to a larger group of employees because they trust them to solve problems correctly rather than pursue their own objectives. By delegating, the CEO can also leverage his or her ability over a larger team. It is thus a more effective channel for the formation of economic networks and transfer of productive know-how. • Decentralisation matters more in heterogeneous environments and for activities that are close to the technology frontier. • Firm size also promotes aggregate productivity growth: optimal resource allocation requires more productive firms to grow and take market share from less productive firms. A notable challenge facing developing economies is that there are “too few” large firms.
<p>Eccles, Ioannou and Serafeim (2014)²⁸</p>	<p>Investigates the effect of corporate sustainability on organisational processes and performance. The study is based on a matched sample of 90 US high sustainability firms and 90 low sustainability firms over the period 1993–2009. A template of corporate policies related to employees, customers, products, innovation and the environment, collected by Thomson Reuters, is used to measure adoption or nonadoption of sustainability practices. For firms that score in the top quartile of sustainability, adoption is validated against third-party reports and interviews with corporate executives.</p>	<p>Propensity score matching is used to produce a group of control firms by sector, size, capital structure, operating performance, and growth opportunities. By matching firms based on policy decisions made as far back as 1993 and thus introducing a long lag between sustainability and performance, concerns over reverse causality are minimised. Findings are robust to different performance metrics, survivorship bias/future default rates and correlated omitted variables such as quality of shareholder-friendly governance.</p>	<ul style="list-style-type: none"> • High sustainability firms significantly outperform their low sustainability counterparts in terms of stock market performance: on a risk-adjusted basis, the difference in performance is 4.8% for a value-weighted portfolio and 2.3% for an equal weighted-portfolio. • High sustainability firms also outperform on accounting-based measures, such as return-on-equity (ROE) and return-on-assets (ROA), suggesting that returns are not driven by price pressure from Socially Responsible Investing (SRI). • High sustainability and low sustainability firms are characterised by distinctive organisational practices, especially in terms of stakeholder engagement, time horizons in communication to investors and disclosure of nonfinancial information. • However, even on those practices where high sustainability firms differ significantly from their counterparts, the absolute percentages are relatively low – possible evidence that the sustainability-performance relation has an inverted U-shape. • The study is based on firms that have a long pedigree of sustainability. An open question is whether results extend to firms that are more recent converts to sustainability.

²⁷ Bloom, N., Sadun, R. and Van Reenan, J. (2012) ‘The Organization of Firms across Countries’, *Quarterly Journal of Economics* 127, 1663–1705.

²⁸ Serafeim, G., Eccles, R. and Ioannou, G. (2014) ‘The Impact of a Corporate Sustainability on Organizational Processes and Performance’, *Management Science* 60, 2835–2857.

<p>Deng, Kang and Low (2014)²⁹</p>	<p>Examines the impact of stakeholder maximisation on merger success, an important aspect of a firm's operations, though one with a high failure rate. The sample consists of 1,556 completed US mergers between 1992 and 2007.</p>	<p>The study uses an instrumental variable design to address potential endogeneity concerns. The instrument exploits variation in religious ranking and party affiliation across US states: firms with high CSR ratings tend to have headquarters located in Democrat and more religious states. Controls are included for acquirer-specific characteristics, product market competition, corporate governance and managerial incentives – factors known to affect merger performance. Findings are robust to alternative industry classifications and measures of CSR performance. The latter is notable as CSR ratings from different raters can exhibit considerable heterogeneity.</p>	<ul style="list-style-type: none"> • Firms with high CSR acquirers experience no significant change in post-merger operating performance while firms with low CSR acquirers typically experience deterioration in their performance. • A long/short strategy that buys acquirers with high CSR and sells acquirers with low CSR is able to generate annual risk-adjusted returns as high as 4.8%, 3.6%, and 3.6% for holding periods of one, two, and three years, respectively. • Mergers proposed by socially responsible firms have a higher likelihood of being completed, and of being completed in less time. • Major customers and suppliers of firms acquired by high CSR firms realise higher merger announcement returns than ones acquired by low CSR firms. Acquirers' bondholders also benefit. • The CSR status of the acquirer firm matters more to performance than the CSR status of the target firm. This echoes other evidence that acquisitions of firms with weak governance by well-governed firms create higher synergistic gains. • The main results persist even after taking into account the agency cost components of CSR policies and the role of unionisation. • Note that the study only considers mergers, not acquisitions. The results do not hold for acquisitions.
<p>Edmans, Li and Zhang (2014)³⁰</p>	<p>Extends Edmans previous work on job satisfaction and performance to 14 countries around the world, exploring their interaction with institutional factors such as labour market flexibility. The sample consists of 552 publicly-listed firms that have more than five years' history of BC listings, including 33 UK firms (2001–2013).</p>	<p>In addition to controls for risk, industry performance and firm characteristics, various country-level variables are included to isolate the impact of labour market flexibility i.e. the rule of law, measures of cultural individualism and GDP growth. Cross-country price efficiency measures are also included to capture the speed with which employee satisfaction is priced in by markets. Results are robust to different portfolio weighting methodologies and the removal of outliers.</p>	<ul style="list-style-type: none"> • Risk-adjusted returns previously found for the US are not the exception in a global context. Indeed, returns in the US, of 34 basis points per month, are only the 10th-highest out of the 14 countries studied. In Japan and the UK, they are 0.77% and 0.81%, respectively (all calculated for an equal-weighted BC portfolio). By contrast, Denmark, Germany and Greece exhibit (insignificantly) negative returns. • Returns are significantly increasing with their country's labour market flexibility. For instance, a one standard deviation decrease in the OECD Employment Protection Legislation index, a measure of labour market rigidity, is associated with a 0.59% higher industry-adjusted monthly return to being a BC. • One explanation is that, in rigid labour markets, regulation already provides sufficient standards for worker welfare and so there is less benefit to the firm doing so. However, in flexible labour markets where employee satisfaction would otherwise be low, increasing it can be a particularly important tool for retention, recruitment and motivation.

²⁹ Deng, X., Kang, J. and Low, B. (2013) 'Corporate Social Responsibility and Stakeholder Value Maximization: Evidence from Mergers', *Journal of Financial Economics* 110, 87–109.

³⁰ Edmans, A., Li, L. and Zhang, C. (2014) 'Employee Satisfaction, Labor Market Flexibility, and Stock Returns around the World'; *NBER Working Paper No. 20300*.

<p>Khan, Serafeim and Yoon (2015)³¹</p>	<p>Tests the emerging concept of ‘materiality’ – the differential importance of different sustainability issues across industries. Exploiting newly available materiality classifications of sustainability issues, the study hand-maps issues classified as material for industries into firm-specific sustainability ratings. Industry classifications are developed by the Sustainability Accounting Standards Board through an extensive process of internal staff research, industry working group and public consultation. Firms are scored against these issues with KLD data. The sample consists of 2307 unique US firms for the period 1993–2013.</p>	<p>Controls are used to control for risk, including liquidity (e.g. five factor model) as well as firm and industry characteristics. Findings are robust to a number of alternative specifications, including different factor models, portfolio weighting methodologies, performance metrics, cut-off values for good and bad performance and the exclusion of so-called sin stocks.</p>	<ul style="list-style-type: none"> • Not all sustainability issues are equally material: firms with good ratings on material sustainability issues significantly outperform firms with poor ratings on these issues. • A portfolio of firms that score high on material issues and low on nonmaterial issues generates annualised risk-adjusted returns of 4.83%. A portfolio of firms with both high performance on material issues and nonmaterial issues, by contrast, generates returns of 1.5%. The fall-off is even more marked for firms that neglect material issues. For a portfolio with low performance on material issues/high performance on nonmaterial issues, risk-adjusted returns are -0.38%. For a portfolio that performs poorly on both material and nonmaterial issues, returns are -2.20% (all calculated on a value-weighted basis with quartile cut-offs). • The correlation between materiality and immateriality scores is moderate (0.3), indicating that sustainability investments are related but sufficiently dissimilar to have different strategic and operational trade-offs for firms. This reinforces the importance of firms distinguishing between the types of investments they make and thinking about sustainability in concrete, not abstract terms.
<p>Guiso, Sapienza and Zingales (2015)³²</p>	<p>Explores which dimensions of corporate culture are related to a firm's performance, in particular the role of integrity. Firms' advertised values are assessed for their link to performance. Proxies for integrity are derived from responses to two distinct questions in the Trust Index employee survey assembled by the Great Place to Work Institute. Employees are asked to express the strength of agreement with the following statements: 'Management's actions match its words' and 'Management is honest and ethical in its business practices.' The sample consists of 679 (294 privately held and 385 publicly traded) US companies over the period 2007–2011.</p>	<p>A novel feature of the study is to control for 'halo effects' in survey responses – the tendency to assume that because a company excels on one dimension (e.g. compensation and benefits), it must be good at everything else (e.g. integrity), however spurious the relationship is in practice. Answers to statements are included that are affected by and can absorb the halo effect, but are uncorrelated with the integrity measure i.e. 'This is a physically safe place to work' or 'I can be myself around here.' A standard set of controls are included for firm value and profitability as well as industry, region and year fixed effects.</p>	<ul style="list-style-type: none"> • Limited evidence that values advertised by firms on their websites or in annual reports affect firm performance, consistent with the idea that many amount to cheap talk. • Integrity is positively associated with financial and economic performance: a one standard deviation increase in integrity results in a 0.19 standard deviation increase in Tobin's Q and a 0.09 standard deviation increase in profitability. It is also associated with a higher level of attractiveness to prospective job applicants. • Integrity cannot be traced to traditional corporate governance measures. The only variable associated with integrity is higher CEO compensation which can be interpreted as a sign that the CEO has more power relative to shareholders to pursue integrity. • Publicly-traded firms appear less able to sustain integrity than privately-held firms: public firms have an integrity value that is 0.21 standard deviations below similar firms that are private. • One exception are venture capital-backed firms that do not suffer any decline after they go public. • This divergence is not attributable to the presence of large shareholders who potentially have longer horizons: in fact, large shareholders have a negative correlation with integrity. Findings must be treated with caution, however. Despite controls for size, industry, quality of employee benefits, geography and demographic characteristics of the firm, additional efforts to address endogeneity are found to be inconclusive.

³¹ Khan, M., Serafeim, G. and Yoon, A. (2015) 'Corporate Sustainability: First Evidence on Materiality', *The Accounting Review*; Forthcoming.

³² Guiso, L., Sapienza, P. and Zingales, L. (2015) 'The Value of Corporate Culture', *Journal of Financial Economics* 117, 60–76.

<p>Friede, Busch and Bassen (2015)³³</p>	<p>Extracts all primary and secondary data from previous academic review studies on ESG. This amounts to more than 2200 unique studies that have been published since the 1970s – a dataset that is 35 times larger than the average number of primary studies analysed in previous review studies.</p>	<p>Only academic studies are considered; single study designs, narrative reviews and review studies without relevant categorisations are excluded. For vote-count studies and meta-analyses, methods are applied to extract distribution of outcomes and effect sizes.</p>	<ul style="list-style-type: none"> • Approximately 90% of studies report a nonnegative relationship between environmental, social, and governance (ESG) criteria and corporate financial performance. • More importantly, the large majority of studies document positive findings – the proportion is 62.6% for meta-analyses that are more sophisticated in methodology than other review approaches insofar as they directly import effect sizes and samples sizes to calculate a summary effect yield. • Within the individual E, S, and G categories, E and G exhibit a slightly more positive relation than S-focused studies. Governance-related aspects have the largest share of positive findings; but also the largest share negative ones. • The positive ESG impact on financial performance appears stable over time (40 years) which presents a puzzle under the assumption of learning effects in capital markets.
<p>Flammer and Kacperczyk (2015)³⁴</p>	<p>Investigates the impact of a firm’s orientation toward stakeholders on innovation following the enactment of constituency statutes in 34 US states for the period 1976–2006. Constituency statutes permit corporate directors to consider stakeholders’ interests when making business decisions – and in cases have seen increased stakeholder representation on their board of directors. Innovation activity is measured by number of patents and number of citations per patent.</p>	<p>The study exploits a quasi-natural experiment that both triggers changes in corporate behaviour and is plausibly exogenous given the introduction of constituency statutes is unlikely to reflect any firm’s strategic decision, including political economy considerations. A difference-in-differences approach is then used to control for contemporaneous changes in innovation unrelated to the statutes e.g. an economy-wide boom – with a treatment group composed of states that adopted the statutes, and a control group composed of states that did not. The staggered introduction of constituency statutes partly addresses the concern that innovation trends may be due to differences between firms in treated and control states. Controls are also included for other firm characteristics that might affect innovation.</p>	<ul style="list-style-type: none"> • The number of patents is found to increase by 6.4% to 6.8% following the enactment of constituency statutes, though typically with a lag of 12–24 months. • The magnitude of this effect appears to increase with time. After 48 months, the number of patents and citations increases by 8%, suggesting that stakeholder orientation has a long-lasting effect on innovation. • Ancillary evidence that a stakeholder orientation results in more original innovations, general innovations and tail innovations (i.e. more hits and flops) which is consistent with the idea that work environments characterised by long-term commitments enhance employees’ innovative efforts and engagement in risky, but potentially mould-breaking projects. • The positive effect of stakeholder orientation on innovation appears stronger in consumer-focused and extractive industries. • More work is necessary to understand the micro-channels through which stakeholder orientation improves firms’ innovativeness. • The enactment of constituency statutes may be an effective policy instrument; understanding its costs and benefits relative to other innovation policies warrants further inquiry.

³³ Friede, G., Busch, T. and Bassen, A. (2015) ‘ESG and Financial Performance: Aggregated Evidence from More than 2000 Empirical Studies’, *Journal of Sustainable Finance & Investment* 5, 210–233.

³⁴ Flammer, C. and Kacperczyk, A. (2015) ‘The Impact of Stakeholder Orientation on Innovation: Evidence from a Natural Experiment’, *Management Science*; Forthcoming.

<p>Albuquerque, Durney and Koskinen (2015)³⁵</p>	<p>Explores the impact of CSR on firms' market or systematic risk, as measured by its beta. CSR is conceptualised as an investment in customer loyalty. Firm-level CSR data are obtained from the KLD database, excluding governance. The sample consists of a panel of ~ 2600 publicly-traded US firms between 2003 and 2011.</p>	<p>To address endogeneity concerns, the study instruments CSR using data on the political affiliation of the firm's home state and data on industry-wide environmental and engineering disasters and product recalls. Controls are included for firm and year fixed effects and variables known to affect systematic risk (e.g. leverage, size, sales growth, earnings variability, conglomerate status) and customer loyalty (e.g. advertising and R&D expenditures).</p>	<ul style="list-style-type: none"> • The level of systematic risk is statistically and economically significantly lower for firms with a higher CSR score. A one standard deviation increase in a firm's CSR score is associated with a firm beta that is 4% lower than the sample mean which has implications for the cost of capital. • The authors attribute this link to the higher customer loyalty generated by CSR which results in not only higher profit margins but also more stable cash flows. • Effects are larger for CSR firms operating in industries with greater product differentiation. • No single CSR dimension is responsible for lower risk, though diversity and environment are found to have the largest economic association. • The profits of CSR firms appear less sensitive to aggregate economic conditions. CSR net profits do not fall as much as those of non-CSR firms during economic downturns; conversely, they do not increase as much during expansions. • Paradoxically, there is evidence that CSR-risk relation is weaker in industries with a larger expenditure share on CSR goods. One possible explanation is that increased consumer spending encourages more firms to adopt CSR policies; the result, however, is that firms with higher adoption costs also implement CSR policies, increasing systematic risk at the margin.
<p>Flammer (2015)³⁶</p>	<p>Analyse the impact of shareholder-sponsored CSR proposals on financial performance – specifically proposals that pass or fail by a small margin of votes. The sample consists of 2,729 CSR proposals that went to a vote from 1997 to 2012 at S&P 1500 and Russell 3000 companies. Of this sample, 61 and 122 proposals received a vote share within ±5% and ±10% of the majority threshold, respectively.</p>	<p>The study uses a regression discontinuity design that permits causal inference. The passage of 'close call' proposals is tantamount to randomly assigning CSR status since companies that pass a CSR proposal with 50.1% of the votes are likely to be similar to companies that reject a CSR proposal with 49.9% of the votes; however, this small difference has a major impact on the probability of the proposal being implemented. Controls are included for standard risk factors as well as firm and meeting fixed effects. Findings are robust to various tests for random assignment, outliers and the confounding effect of adopting general governance proposals.</p>	<ul style="list-style-type: none"> • A close-call CSR proposal that is implemented yields a risk-adjusted return of 1.77%. • Adoption is associated with a long-term improvement in operating performance (i.e. return on assets, net profit margin and return on equity). This is driven principally by increases in labour productivity and sales growth. • Investments in CSR are found to exhibit diminishing marginal returns, with gains nearly as twice as large for companies that have relatively low levels of CSR. • Not all CSR proposals appear to be beneficial. With an average vote outcome of 13.5%, most proposals are perceived to be of limited value in the eyes of shareholders, though this may partly reflect a lack of information. • Close-call proposals are distinctive in several respects: they are more likely to address employee satisfaction and environmental issues; they focus largely on the performance aspects of CSR and are more frequently found among companies in 'stakeholder-sensitive' industries (i.e. labour-intensive and business-to consumer industries). This implies caution when generalising results to non-close-call proposals. • While these CSR proposals are beneficial to shareholders, the benefits are not as large as those reported for governance-type proposals, notably say-on-pay.

³⁵ Albuquerque, R., Durney, A. and Koskinen, Y. (2015) 'Corporate Social Responsibility and Firm Risk: Theory and Empirical Evidence'.

³⁶ Flammer, C. (2015) 'Does Corporate Social Responsibility Lead to Superior Financial Performance? A Regression Discontinuity Approach', *Management Science* 61, 2549–2568.

<p>Lins, Servaes and Tamayo (2016)³⁷</p>	<p>Investigates the extent to which a firm’s social capital benefited performance during the 2008–2009 financial crisis. CSR strength is deemed an appropriate proxy for firm-level social capital, which has support in empirical work, though is not the only metric and has its limitations. The sample consists of 1,841 US non-financial firms with CSR data available on the MSCI ESG Stats database.</p>	<p>The financial crisis is used as an exogenous shock to investor trust, mitigating endogeneity concerns. Levels of corporate social responsibility are assumed to be stable, at least in the short term. Controls are included for various risk factors, industry affiliation, firm characteristics and measures of financial health (e.g. cash holding, short- and long-term debt and profitability) that might affect performance in a crisis situation. Findings are robust to measuring CSR performance at different points in the crisis period window; the inclusion of microcaps with low liquidity in the sample and several subcomponents of corporate governance measuring entrenchment and transparency.</p>	<ul style="list-style-type: none"> • Social capital provides valuable insurance during periods of investor and economic uncertainty when there is a premium on being identifiably trustworthy. • High CSR firms have crisis-period stock returns that are four to five percentage points higher than for low CSR firms, though the impact of CSR on returns is not entirely linear across the distribution: the greatest improvement in returns is linked with a move from the lowest to the 2nd quartile of CSR and with a move from the 3rd to the 4th quartile. • The contribution of social capital to returns is at least half as large as the effect of cash holdings and leverage. • High-CSR firms also enjoy superior operating performance during this period that appears to accrue through customer and employee channels. For instance, customers are more willing to stick with firms during bad times, as reflected in higher sales growth and an acceptance of higher mark-ups. • These findings generalise to other ‘crisis’ periods – for instance the Enron/Worldcom accounting scandals of the early 2000s. • On the other hand, high CSR firms do not seem to earn excess returns in the period of high economic growth before the crisis (January 2004–July 2008) or after the crisis (April 2009–December 2013) which prima facie departs from the findings of other studies.
---	--	--	--

³⁷ Lins, K., Servaes, H. and Tamayo, A. (2016) ‘Social Capital, Trust, and Firm Performance: The Value of Corporate Social Responsibility during the Financial Crisis’, *European Corporate Governance Institute (ECGI)*; Finance Working Paper No. 446/2015.

Embedding purpose

Making purpose work in business terms is still work in progress. Indeed social psychological research tells us just how hard it is to exert self-control in our lives.³⁸ Being purposeful is not easy, particularly where large numbers of employees and partners are involved and considerable investments have been made in specialised assets.

Most companies both in the FTSE 100 and S&P 500 devote some pages in their annual reports to setting out their purpose, and from that their mission and values. However, there is a wide dispersion in the values that firms champion in part because it is so easy to claim rather than live them.³⁹ Sometimes even purposed firms are exposed very publicly for not living up to their stated ideals, but as human organisations such shortcomings can be expected. It does not mean companies should give up on the attempt: rather they should redouble their efforts.

To integrate purpose, firms must move beyond lofty abstractions and aspirations. They need to demonstrate in concrete terms what purpose means to them – and how they use it to prioritise what they are doing, particularly when under pressure. They must also show how to sustain or adjust their purpose if they come close to achieving it – or if circumstances change. The plucky start-up that has gone on to be an industry giant can no longer plead it is challenging incumbents. Purpose is a living narrative.

Complementarity in operating models and sustainability practices

A particular challenge is that the sustainability issues that are central to a firm's long-run performance differ across industries.⁴⁰ Not every firm is affected in the same way by the same issues. Thus sectors such as oil, gas and utilities are more likely to care about risks arising from climate change, ecosystem sensitivity and accident and safety management. In healthcare, social capital issues such as access and affordability, customer welfare and fair advertising are higher priority where costs show no signs of abating; while technology companies confronted with the opportunities and challenges of big data and monopoly power will deem issues such as data security, privacy and competition more material. Apple's refusal to cooperate with FBI demands to unlock an iPhone linked to terrorism is a graphic illustration of this preoccupation.

Companies are starting to identify the specific issues that are most important to them. Companies such as Unilever, DSM, Nestlé, Rabobank and Tesco have started to carry out their own exercises, based on substantial stakeholder engagement to identify which issues impact on revenues, cost structure, supply

³⁸ Baumeister, R. and Heatherton, T. (1996) 'Self-Regulation Failure: An Overview', *Psychological Inquiry: An International Journal for the Advancement of Psychological Theory* 7, 1–15; and De Ridder, D., Lensvelt-Mulders, G., Finkenauer, C., Stok, F. and Baumeister, R. (2012) 'Taking Stock of Self-Control: A Meta-Analysis of How Trait Self-Control Relates to a Wide Range of Behaviors', *Personality and Social Psychology Review* 16, 76–99.

³⁹ Graham, J., Harvey, C., Popadak, J. and Rajgopal, S. (2015) 'Corporate Culture: Evidence from the Field'; Working Paper.

⁴⁰ Khan, M., Serafeim, G. and Yoon, A. (2015) 'Corporate Sustainability: First Evidence on Materiality', *The Accounting Review*; Forthcoming.

chains, risk and reputation. In the US, the Sustainability Accounting Standards Board (SASB) is developing standards to help companies disclose material factors in compliance with SEC requirements.⁴¹ Central to this work is the creation of Materiality Maps that use a range of sustainability criteria to rank their materiality for any given industry. Maps now exist for 80 industries in 10 sectors and each goes through a rigorous process of internal staff research, industry working group and public consultation. As of February 2015, 2,360 experts representing \$23.1 trillion in AuM and \$9.8 trillion in company market capitalisation had participated in this process.

Having identified the most material issues at a sector or industry level, it is important that a firm’s competitive advantage and organisational practices are aligned. A McKinsey study finds that companies follow one of four “archetypes.”⁴² Some companies compete on the basis of market focus – building a portfolio of strong brands and anticipating market trends; some view their talent or knowledge pool as their main asset; some depend on execution and the ability to eke out continuous improvements in quality and productivity; and some are leadership-driven – prioritising the development of talented, high-potential leaders at all levels of the organisation.

Each of these archetypes is associated with a bundle of five to six distinctive management practices (see Figure 1.3). Companies strongly aligned with one of them are five times more likely to be healthy and deliver strong, sustained performance than companies that take a more haphazard approach. Specifically, 73% of these companies enjoy top quartile organisational health, provided that they achieve a reasonable standard (above bottom quartile) on the remaining practices.

Figure 1.3: Top 5 out of 37 management practices prioritised by companies that follow given approach

Leader driven	Market driven	Execution edge	Talent and knowledge core
Career opportunities	Customer focus	Knowledge sharing	Rewards and recognition
Inspirational leaders	Competitor insights	Employee involvement	Talent acquisition
Open and trusting	Business partnerships	Creative and entrepreneurial	Financial incentives
Financial incentives	Financial management	Bottom-up innovation	Career opportunities

⁴¹ See <http://www.sasb.org/>

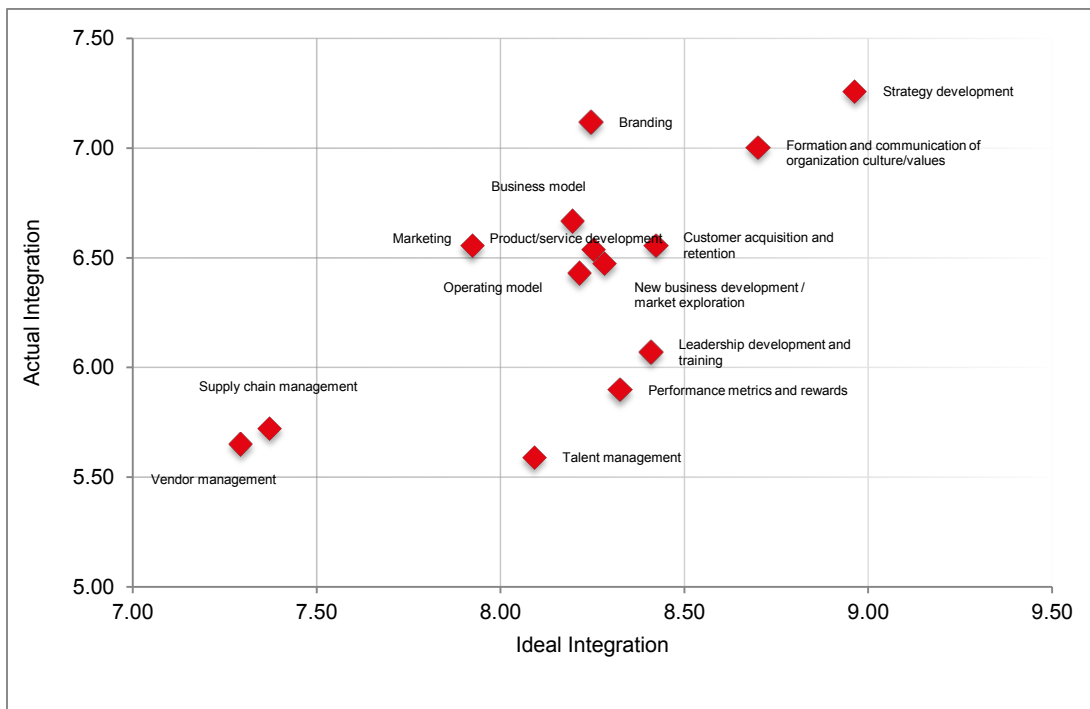
⁴² Keller, S. and Price, C. (2011) ‘Beyond Performance: How Great Organizations Build Ultimate Competitive Advantage’; John Wiley & Sons.

Risk management	Government / community relationships	Talent development	Personal ownership
-----------------	--------------------------------------	--------------------	--------------------

Source: McKinsey

This is not to say that every alignment challenge is particular to company strategy and sector. All companies find the challenges problematic. A recent survey from EY Beacon Institute and Harvard Business Review Analytic Services points to a number of activities or functions in which companies struggle to integrate purpose, highlighting where the gap between actual integration and ideal integration is most pronounced (see Figure 1.4).⁴³ The role of performance metrics and rewards is fully explored in Chapter 3, with policy options in Chapter 5.

Figure 1.4: How important is it for an organisation’s purpose to be integrated into each of the following areas? To what extent is your organisation’s purpose actually integrated into each of the following functions and activities?



Source: Harvard Business Review Analytic Services and EY Beacon Institute

Leadership and managing change

⁴³ (2015) ‘The Business Case for Purpose’, *Harvard Business Review Analytic Services*; Report sponsored by and co-produced with EY Beacon Institute.

It is difficult to underestimate the role of senior management in embedding purpose.⁴⁴ Leaders set the tone for others in the organisation as to what really matters, permitting consistent decisions. McKinsey finds that large-scale change is 2.6 times more likely to succeed if it has strong involvement from the top of the organisation. However, as Figure 3 indicates, very few companies appear to do this well. Part of the problem is that leaders overestimate their effectiveness: while 86% of senior executives believe that they are actively demonstrating the change they want employees to make, only 53% of employees do.⁴⁵

Beyond this, leaders can credibly commit to purpose in ways that make decisions harder to undo. One simple option is to let go or refuse to promote individuals who do not support this change. Jack Welch made no exceptions: “If you get results without living the values, I’m coming for you.” Alternatively, they can submit to public reporting of purpose-related data, sign up to voluntary codes such as the Global Compact facilitated by the United Nations or undergo third-party appraisal. Consumer goods giant Unilever, for example, has considered becoming a B corps, an entity certified by the Pennsylvania NGO, B Labs, as contributing social and environmental benefits beyond the financial bottom line. B Labs has certified roughly 1600 companies in 47 countries and has recently established a Multinationals and Public Markets Advisory Council to explore ways to remove obstacles to adopting mission-aligned corporate structures suitable for the size and scope of large listed companies – an option for change we consider in Chapter 5.

Another popular mechanism is to appoint a chief sustainability officer (CSO) that is charged with day-to-day responsibility for the company’s purpose.⁴⁶ This ranges from educating employees through learning from external sources and designing metrics to managing stakeholder relations. The number of companies with a CSO doubled between 1995 and 2003, and then doubled again between 2003 and 2008. Officers in companies that are most serious about this role are more likely to report to the CEO or the board of directors, often with support from a separate sustainability committee, though interestingly, their responsibilities are more likely to be narrowly defined. This possibly reflects the fact that purpose is no longer understood as a bolt-on activity and CSOs are able to delegate responsibilities to champions around the organisation.

This captures a larger point: embedding purpose must be more than a top-down, episodic process. It must engage as many people and groups as possible, though the involvement of mid-level managers that bridge the gap in understanding that often lies between strategy and operations is particularly important. When Sam Palmisano became IBM CEO in 2002 he made repurposing the company’s century-old values a priority. Employees and selected partners were given the opportunity to shape this process by participating in a ValuesJam, an extended web-based discussion. Nearly 140,000 did. Out of it emerged a new set of values, including IBM’s Smarter Planet strategy. DuPont is another example of a company that has routinely engaged in collective reflection about its identity and how to live it – arguably one reason why it has been able to navigate numerous market and industry cycles and reinvent itself from a

⁴⁴ Nohria, N. and Khurana, R. eds. (2010) ‘Handbook of Leadership Theory and Practice’; Harvard Business Press.

⁴⁵ Bazigos, M. and Caruso, E. (2016) ‘Why Frontline Workers are Disengaged’, *McKinsey Quarterly*, March.

⁴⁶ Perkins, K. and Serafeim, G. ‘Chief Sustainability Officers: Who Are They and What Do They Do?’ in Henderson, R., Gulati, R. and Tushman, M. (2015) *Leading Sustainable Change: An Organizational Perspective*; Oxford University Press.

chemicals conglomerate to a broad-based science company with a focus on biotechnology.

Without such buy-in, momentum can quickly stall. Models of collective action show that the motivation to support change often increases with the number of supporters.⁴⁷ In most organisations, early adopters typically represent 10–15% of the workforce.⁴⁸ Enlisting their support can therefore lower the threshold required for others to commit to change in a self-reinforcing cycle. Adam Grant in his book *Originals: How Nonconformists Move the World* provides an alternative perspective.⁴⁹ He argues that concerted efforts to win over opponents can have even larger payoffs, if successful. Former opponents can wield better arguments on behalf of new initiatives as they understand the reservations of others; and because they have not been simple cheerleaders, their arguments are likely to carry greater credibility.

Over time, these issues become simultaneously easier and more challenging – easier because prior success will reduce resistance to change; more challenging because once low-hanging fruit has been picked, subsequent initiatives are likely to entail greater uncertainty and complexity and with it, potentially longer periods in which performance may drop before improvements kick in.

While there are no guarantees of success, some companies have found effective ways of managing this process – providing small-scale, low-risk opportunities for the search, trial, evaluation and adoption of new commitments. Options include establishing micro loan funds to finance purpose-based programmes, using returns to roll out larger ones; running ‘hackathons’ in which employees can follow their interests and generate ideas for new goods and services; and establishing dedicated units to explore cross-line-of-business opportunities which are supported by looser accountability structures such as milestone reporting and strategic and financial tracking.⁵⁰

The importance of external communication

The implementation journey that a company takes is not only internally driven but also outward facing. Organisations are shaped by the wider ecosystem – its logic and sources of legitimacy – in which they are embedded. Change can be unruly without a means to explain what is going on so that shareholders and stakeholders can see the context, understand the full range of options and trade-offs and adjust their expectations accordingly. External communication is therefore essential for companies to capture value from their investments and attract parties who are more willing to look beyond short-term considerations. Indeed some companies are going even further and engaging in co-production activities with users, customers, suppliers, and forming inter-firm collaborations, which are not simply transactional alliances. Such endeavours are held together by ‘shared need’ – out of which collective understandings of purpose

⁴⁷ Jackson, M. (2008) ‘Social and Economic Networks’; Princeton University Press; Ferguson, W. (2013) ‘Collective Action and Exchange: A Game-Theoretic Approach to Contemporary Political Economy’; Stanford University Press.

⁴⁸ Rogers, E. (2013) ‘Diffusion of Innovations’; Simon Schuster, 5th Edition.

⁴⁹ Grant, A. (2016) ‘Originals: How Nonconformists Change the World’; Viking Press.

⁵⁰ Sterman, J. ‘Stumbling towards Sustainability: Why Organizational Learning and Radical Innovation are Necessary to Build a More Sustainable World – But Not Sufficient’ in Henderson, R., Gulati, R. and Tushman, M. (2015) *Leading Sustainable Change: An Organizational Perspective*; Oxford University Press.

are developed and internalised.⁵¹

Despite the benefits conferred by communication, it features low down the agenda of many companies. *Triple Pundit*, a prominent media outlet covering sustainability issues, lists the lack of communication and indiscriminate communication as the top two mistakes firms make regarding this agenda. A firm's market value depends not only on the sum of purpose-based activities but also on their degree of alignment. A company must act as it says it intends to act, not hope its actions speak for themselves without communicating them. Specifically, the wider the gap between a firm's external and internal actions, the lower its market value.⁵² This echoes other research that finds a positive sustainability-value relation for companies with high consumer awareness, as measured by advertising expenditures and a strong prior reputation as corporate citizens.⁵³ The object of communication is not to broadcast for broadcasting sake, but to achieve results internally and externally: to mobilise for change.

This assumes particular significance in the context of corporate–investor relations where initial scepticism over purpose among shareholders may be quite considerable. To address this, as we discuss among various policy options, companies can use segmentation approaches to identify the most committed, long-term investors and concentrate messages around their needs. This can be done by breaking down the investor base by investment portfolio concentrations, the number of professionals involved in investment decisions, average trading volumes, holding periods and the level of research necessary to trade, with implications for small group investor meetings, Investor Days, reporting statements and earnings communications.⁵⁴

However, there remain limits to what even the most committed companies can achieve in terms of industry leadership and shaping norms. Whatever the advantages of purpose, it can get pushed to the margins given the magnitude of today's uncertainties and different expectations of what purpose means from varying stakeholders. How purpose is understood at the front line may differ from how management has conceived purpose, which can result in a decoupling of policy from practice.⁵⁵ Nor do consumers help if they do not match their values with their purchases. As we discuss in Chapter 5's policy options, it may be that there has to be legal and regulatory reform to deliver common protocols along with the accompanying clarity.

⁵¹ Harhoff, D. and Lakhani, K. eds. (2016) 'Revolutionizing Innovation: Users, Communities, and Open Innovation'; MIT Press.

⁵² Hawn, O. and Ioannou, I. 'Mind the Gap: The Interplay between External and Internal Actions in the Case of Corporate Social Responsibility', *Strategic Management Journal*; Forthcoming.

⁵³ Servaes, H. and Tamayo, A. (2013) 'The Impact of Corporate Social Responsibility on Firm Value: The Role of Customer Awareness', *Management Science* 59, 1045–1061.

⁵⁴ Focusing Capital on the Long Term (2015) 'Straight Talk for the Long-Term: An In-depth Look at Improving the Investor–Corporate Dialogue'.

⁵⁵ Crilly, D., Zollo, M. and Hansen, M. (2012) 'Faking It or Muddling Through? Understanding Decoupling in Response to Stakeholder Pressures', *Academy of Management Journal* 55, 1429–48. This need not be a bad thing if this leads to bottom-up experimentation 'muddling through'; however where commitment to purpose is low, it can easily lead to evasion and opportunism 'faking it'.

Learning from Leading Firms

At a firm level it is too early to have strong evidence about how to embed purpose successfully. Paul Polman, Chief Executive of Unilever, confirms how demanding on both business model and internal organisation the commitment to purpose is “to make sustainable living commonplace. We work to create a better future every day, with brands and services that help people feel good, look good, and get more out of life.” Polman describes that he has initiated 3 big areas of change:

- the development of a 'growth mind set';
- conscious decision making around how Unilever competes and grows; and
- the reinvention of operating practices.

In a 2014 Interview with McKinsey, Polman explains further⁵⁶:

“The first thing is mind-set. When I became chief executive, in 2009, I said, ‘We’re going to double our turnover.’ People hadn’t heard that message for a long time, and it helped them get back what I call their ‘growth mind-set.’ You simply cannot save your way to prosperity. The second thing was about the way we should grow. We made it very clear that we needed to think differently about the use of resources and to develop a more inclusive growth model. So we created the Unilever Sustainable Living Plan, which basically says that we will double our turnover, reduce our absolute environmental impact, and increase our positive social impact.

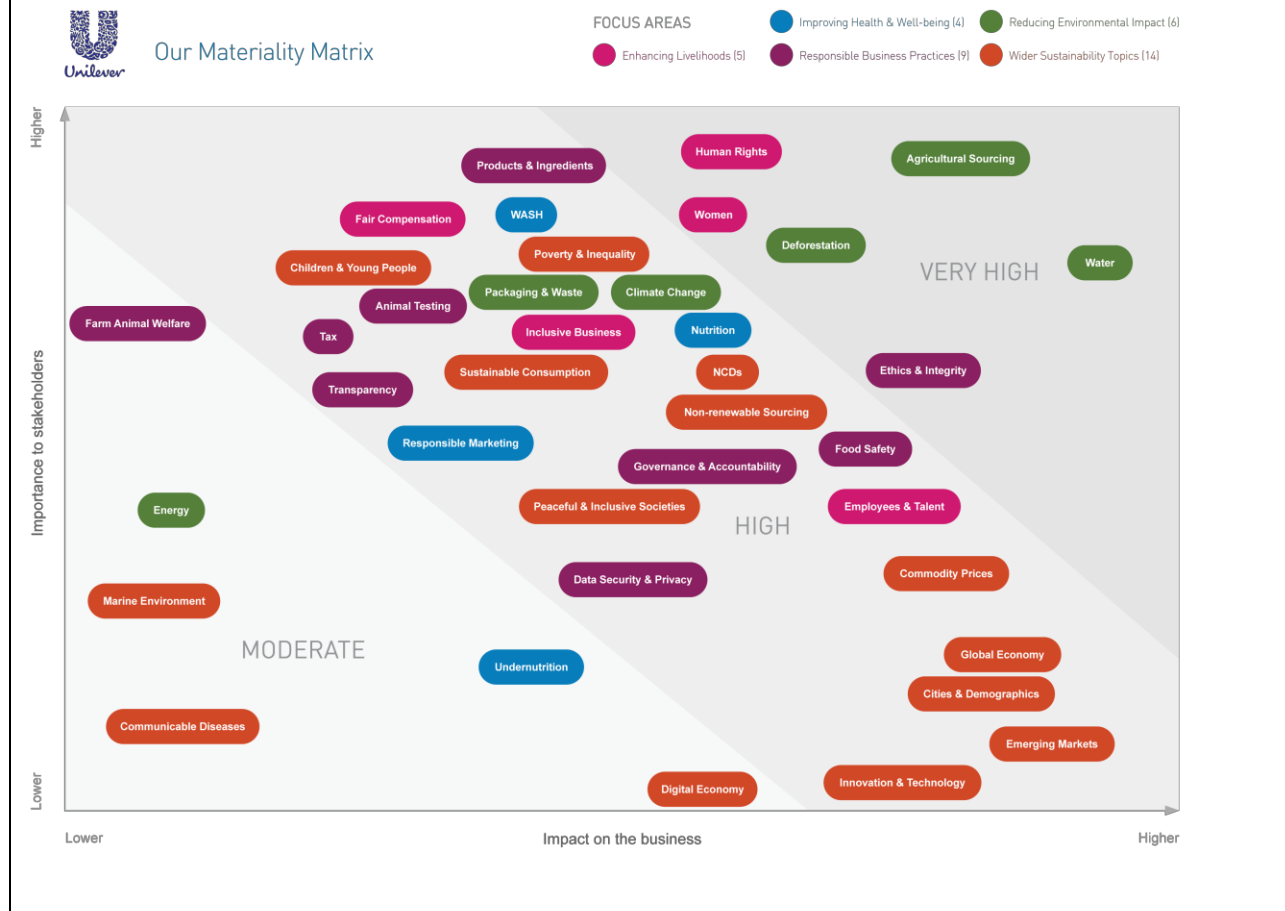
Because it takes a longer-term operating model to address these issues, I decided we wouldn’t give guidance anymore and would stop full reporting on a quarterly basis; we needed to remove the temptation to work only toward the next set of numbers. Our share price went down 8% when we announced the ending of guidance, as many saw this as a precursor to more bad news. But that didn’t bother me too much; my stance was that in the longer term, the company’s true performance would be reflected in the share price anyway’.

‘...we also altered the compensation system to bring in some incentives related to the long term. Ultimately, a year or so was needed to make it very clear internally that we were focused on the long term, on sustainable growth. To reinforce that message externally we focused our effort more on attracting the right longer-term shareholders to our share register.”

Unilever has spearheaded the use of materiality analysis, rendering non-financial reporting more professional. It first carried out an in-depth materiality assessment in 2009–2010 when developing the Unilever Sustainable Living Plan. Most recently, it was updated in 2015. A total of 191 issues have been identified and grouped into 38 topics or 5 focus groups. The resulting matrix reflects both internal and

⁵⁶ Polman, P. (2014) ‘Business, Society and the Future of Capitalism’, *McKinsey Quarterly*, May.

external perspectives on sustainability topics and their relative significance to Unilever’s business and stakeholders.⁵⁷



Conclusion

Firms recognise the value of purpose driving win/win outcomes for employees, customers and the wider society, understanding it is essential to performance – and growing more so in the world of knowledge and ideas. A substantial body of micro-economic evidence supports this proposition across the spectrum of business outcomes. Most if not all firms reference purpose in their communications both internally and externally for this reason. However embedding purpose successfully is challenging and at best accomplished in a handful of firms. To what extent are ownership, governance and the wider ecosystem structures supportive of such initiatives? It is to those questions we now turn.

⁵⁷ https://www.unilever.com/Images/unilever-materiality-matrix-final_tcm244-476008_en.pdf

2. Rights and wrongs

Shareholder rights

The company is a legal structure designed to bring together the different parties to the firm – its employees, investors, customers and suppliers – in the delivery of its corporate purpose. Corporations were established as institutions with autonomous lives as self-standing legal entities independent of those who worked, financed and managed them. They were devices to ensure long-term commitment to shared goals and risks, with reciprocal obligations on those engaged in them. A company had to declare its purpose before earning a licence to trade. For example, the East India Company, England's earliest public company to issue shares to the public as permanent capital, was given the monopoly of English trade in Asia with reciprocal obligations to protect trade along its routes. There was a mutual relationship between the company and society and a mutual benefit to both.⁵⁸

This was carried through to the 18th and 19th centuries with canal and railway companies operating under charter to deliver on a public purpose. It was with freedom of incorporation in the middle of the 19th century that the focus on public purpose gave way to private interest. Nevertheless, public benefit remained at the heart of many private companies with the families who owned them, such as Cadbury and Rowntree's, having an interest in wider social purpose beyond pure financial gain. However, to meet the needs for growth in industrial firms in the 20th century, equity was issued for internal investment and acquisition that diluted the families to the point that they lost control of their companies. Public markets provided capital that promoted economic development and brought transparency to what were previously opaque private firms. However, this came at a price in the separation of ownership from the control of firms.

With the separation of ownership and control came a concern, expressed most forcefully by Adolf Berle and Gardiner Means in 'The Modern Corporation and Private Property', about the need for shareholders to reassert their authority over corporations to ensure that they were run in the interest of their owners not the self-interest of their managers. The truth, largely forgotten, is that this argument was embedded in a larger vision that wanted economic and political power in all its guises, to be exercised to benefit the community at large. This pluralist frame of reference subsequently fell out of view, with consequences that reverberate today.⁵⁹ So was born what has become a preoccupation ever since with the 'agency problem' in the modern corporation of aligning the interests of managers with those

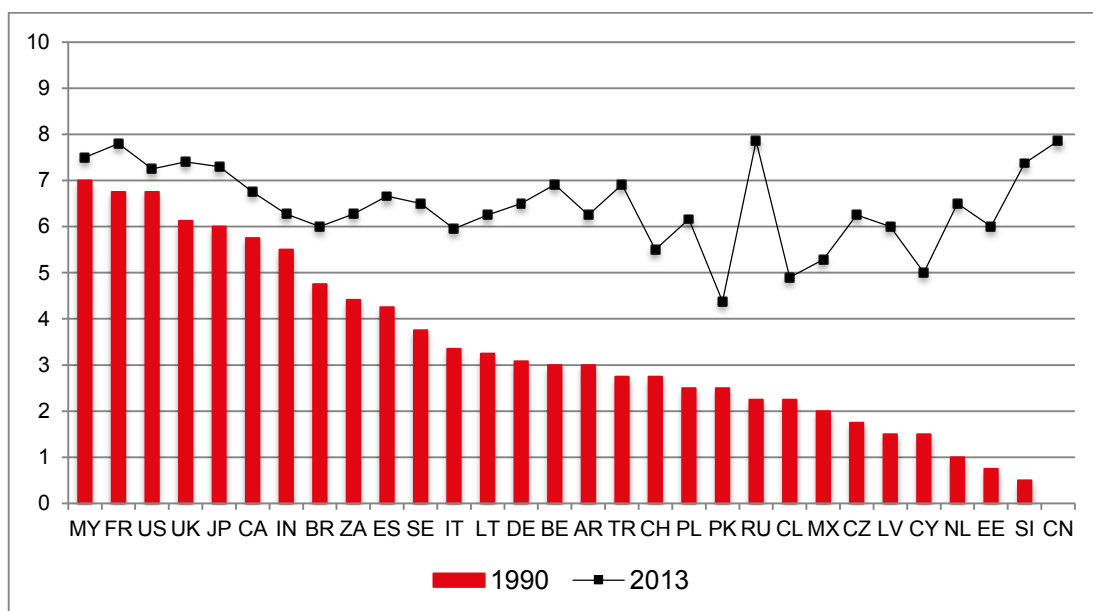
⁵⁸ Mayer, C. (2016) 'Reinventing the Corporation', *Journal of the British Academy* 4, 53–72.

⁵⁹ Strine, L. (2014) 'Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law', *Columbia Law Review* 114, 449–502. See also Tsuk, D. (2005) 'From Pluralism to Individualism: Berle and Means and 20th-Century American Legal Thought', *Law & Social Inquiry* 30, 179–225.

of their shareholders to avoid unprofitable growth or undue complacency.

The common response has been the strengthening of shareholder rights. As Figure 2.1 shows there has been a marked increase and convergence in investor protection in all major industrialised countries over the past 20 years, regardless of their legal traditions and stage of development. In some countries, such as China, Germany and Sweden, it has been very pronounced. In others, such the UK and US, shareholder protection was already well established at the beginning of the 1990s and has only experienced modest changes since.⁶⁰

Figure 2.1: Shareholder protection in thirty countries in 1990 and 2013



Source: The Law, Finance and Development Project

The above graph, from the Law, Finance and Development project at the University of Cambridge, presents an aggregate of ten variables that act as proxies for shareholder protection law for the years 1990–2013. Each variable is scored between 0 and 10, with the possibility of intermediate scores (0=minimum, 10=maximum strength of protection). Variables include: powers of the general meeting for de facto changes; agenda setting power; anticipation of shareholder decision facilitated; prohibition of multiple voting rights (super voting rights); independent board members; feasibility of director’s dismissal; private enforcement of directors duties (derivative suit); shareholder action against resolutions of the general meeting; mandatory bid; and disclosure of major share ownership (Siems, 2015).

The justification for the strengthening of shareholder rights is twofold. First, in the context of

⁶⁰ Siems, M. (2014) ‘Comparative Law’; Cambridge University Press; Katelouzou, D and Siems, M. (2015) ‘Disappearing Paradigms in Shareholder Protection: Leximetric Evidence for 30 Countries, 1990–2013’, *Journal of Corporate Law Studies* 15, 127–160.

dispersed ownership systems such as the UK and the US, it provides a countervailing power to that of corporate executives and managers who control corporate assets. Second, in more concentrated ownership systems that are commonplace outside of the UK and US, it gives minority investors protection against the dominant shareholders who can exploit their power to the detriment of other shareholders.

If equity markets are to operate efficiently as allocators of resources and monitors of the use of capital, then minority shareholders as residual claimants need to have the means of protecting themselves against both management and dominant shareholders – a truth recognised in all countries.⁶¹ Their rights therefore ensure that the policies and practices of companies are consistent with value creation not value diversion for the benefits of vested interests.⁶²

There is no doubt that shareholder rights have been important in avoiding the conflicts identified by Berle and Means some 80 years ago. The question is whether they go far enough in protecting not only the interests of minority shareholders but also all those of the other parties who are critical to corporate success and also vulnerable to sectional interests.

The right balance

Shareholder rights are not ends in themselves. In seeking to right the wrong identified by Berle and Means we have lost sight of its original purpose. Owners are shareholders but shareholders are not always owners. Owners are engaged shareholders. They are involved in the oversight and sometimes the management of firms. They appoint the executive and the board of companies and they monitor their performance. They may define the purpose of the company and assist the executive in the delivery of it. If the executive fails then they

⁶¹ Levine, R. (2005) 'Finance and Growth: Theory and Evidence', in Aghion, P. and Durlauf, S eds., *Handbook of Economic Growth*; Elsevier. See also Demirgüç-Kunt, A. and Maksimovic, V. (2002) 'Funding Growth in Bank-based and Market-based Financial Systems: Evidence from Firm-level Data', *Journal of Financial Economics* 65, 337–363. For work that focusses on the financing of innovation, see Brown, J., Martinsson, G. and Petersen, B. (2013) 'Law, Stock Markets, and Innovation', *Journal of Finance* 68, 1517–1549.

⁶² Gompers, P., Ishii, J. and Metrick, A. (2003) 'Corporate Governance and Equity Prices', *Quarterly Journal of Economics*, 118, 107–156. The authors find that that well-governed firms beat poorly governed firms by 8.5% per annum on constructed governance or G-index. Given the influence of paper, particularly in pioneering the use of corporate governance indices in empirical work, it has given rise to substantial discussion. See Core, J., Guay, W. and Rusticus, T. (2006) 'Does Weak Governance Cause Weak Stock Returns? An Examination of Firm Operating Performance and Investors' Expectations', *Journal of Finance* 61, 655–687 and Johnson, S., Moorman, T. and Sorescu, S. (2009) 'A Reexamination of Corporate Governance and Equity Prices', *Review of Financial Studies* 22, 4753–4786, suggesting that market models used by the paper have been misspecified. For studies that address these concerns and find that basic results still hold, see Giroud, X. and Mueller, H. (2011) 'Corporate Governance, Product Market Competition, and Equity Prices', *Journal of Finance* 66, 563–600 and Masulis, R., Wang, C. and Xie, F. (2007) 'Corporate Governance and Acquirer Returns', *Journal of Finance* 62, 1851–1889. For a legal perspective on how corporate governance indices are used and misused in empirical work, see Klausner, M. (2013) 'Fact and Fiction in Corporate Law and Governance' *Stanford Law Review* 65, 1325–1370.

seek its replacement. In particular, unlike disengaged shareholders, they accept responsibilities as well as rights – responsibilities to ensure that the company delivers on its purpose and to bear at least some of the consequences for its failure to do so.

Shareholders are investors. They provide capital, they earn returns from their investments, they receive reports on the performance of their investments and they sometimes cast votes at shareholder meetings. The distinction between owners and shareholders is critical to understanding the ability of companies to be able to define, uphold and deliver on purpose. Disengaged shareholders have an interest in the financial performance of the firm but no more. The purpose of the corporation from their perspective is to generate as large a financial return as possible with little consideration as to how it is done.

From the perspective of the disengaged shareholder, corporate purpose appears at best little more than branding gloss, at worst an active impediment. An obligation to a purpose risks shackling the firm from pursuing of the most profitable opportunity. This scepticism is rooted in the belief that the costs of disengaged ownership are outweighed by the benefits of disengaging from ownership obligations. But purpose is about creating an asset that extends beyond the bricks and mortar and even the human capital of the business – it is about creating and underpinning the intangible assets that increasingly dominate the value of tangible assets.

This is where the distinction between owners and shareholders is critical. Shareholders can derive the benefits of intangible assets but in so doing they threaten their preservation. Reputations need to be nurtured and protected from those shareholders who place a high value on the short-term benefits of exploiting them. That is the role of engaged owners – they have interests in promoting, protecting and preserving the corporation to enhance its reputational capital. That is why the apparent attraction of being liberated from the shackles of purpose can be illusory and why the presence of owners who define and preserve purpose can benefit not undermine disengaged shareholders. The open question is how to promote ownership while simultaneously recognising that even committed owners sometimes need to sell, that the ability to sell is fundamental to share ownership, and that sometimes the threat and reality of selling, or exiting, has an important disciplinary impact on managements. At present the bias is to emphasise the shareholder as investor; too little on the shareholder as owner.

Shareholder rights are one and only one means of promoting the efficient running of the corporation as a legal structure designed to bring together the different parties to the firm in the delivery of its corporate purpose. The corporation should protect the interests of its minority investors but it also needs to protect the interests of the other parties – creditors, employees, customers, suppliers and communities – involved in its corporate purpose. Where the shareholder rights movement has erred is in unbalancing the corporation by

emphasising the interests of short-term shareholders over other parties.⁶³

This is sometimes discussed in the context of what is described as the ‘stakeholder’ view of the firm in which the rights of such parties as employees, suppliers and communities are emphasised in relation to those of shareholders. While this approach is correct in pointing to the significance of other parties, it errs in the opposite direction of seeking to confer control on employees through mutual ownership, customers in cooperatives, or society in the form of corporatism and public ownership. There is room for all of these and one of the points we will be emphasising later in the report is the significance of permitting and promoting plurality of corporate forms. But this is again to miss the point by looking at the firm in terms of its constituent parts.

The starting point should be the definition of corporate purpose as set out in the first chapter and the promotion of it through the participation of all relevant parties. This is achieved not simply by conferring control on one particular group be it minority shareholders, employees or customers but by respecting their collective interest in the delivery of corporate purpose. The achievement of corporate purpose involves the judicious balancing of the interests of different parties and ensuring that their incentives are aligned with those of the company as a whole.

Key to this is the ability of companies to commit to their different interest groups. Commenting on Colin Mayer’s book⁶⁴ FT economics columnist Martin Wolf further develops the argument:

“A company whose goal is whatever seems profitable today can be trusted only to renege on implicit contracts. It is sure to act opportunistically. But long-term commitments will only work if it is costly for the parties to act opportunistically. Moreover, it is often in the interests of all parties to bind themselves not to behave in such a way. But, with an active market in corporate control, such commitments cannot be made. Those who make the promises may disappear before they can deliver [...] Long-term commitments could in theory be managed instead by trying to specify every eventuality. About a second’s thought makes it clear that this is impossible. It would not just be inconceivably complex and costly. It would come up against the deeper problem of uncertainty. We have little idea of what might happen in the next few months, let alone the next few decades. If people are to make long-term commitments, trust is the only alternative. But a company whose goal is whatever seems profitable today can be trusted only to renege on implicit contracts. It is sure to act opportunistically. If its managers did not want to do so, they would be replaced. This is because, as Prof Mayer argues: “The corporation is a rent extraction vehicle for the shortest-term shareholders.” Aligning managerial rewards to shareholder returns reinforces the

⁶³ Even if no shareholders are short-termist, the fact that they can in principle sell their shares at any time may make it harder for them to commit ex ante to other stakeholders or longer investments.

⁶⁴ Mayer, C. (2013) ‘Firm Commitment: Why the Corporation is Failing Us and How to Restore Trust in It’; Oxford University Press.

*opportunism.*⁶⁵

This concept of commitment shifts the view of the corporation from a top down instrument of its shareholders to an entity in its own right designed to fulfil its corporate purpose through integrating the interests of its constituent parts as a whole. Shareholders are one and only one part of that entity and shareholder returns are one and only one measure of its success. Integration requires a corporate culture that is conducive to a unified pursuit of purpose.

Corporate culture

The importance of corporate culture in unifying the pursuit of purpose has been documented in extensive case studies of companies such as First Chicago, Hewlett-Packard, ICI, Nissan and Xerox.⁶⁶ Jillian Popadak explores how a company's strategic decision making is affected by interventions from shareholders by exploring what happens when there are close votes on resolutions at shareholder meetings.⁶⁷ She contrasts companies where propositions just go through with those where they fail. Even though the firms are in other respects identical, Popadak documents significant differences in the subsequent evolution of their culture and performance after the votes.

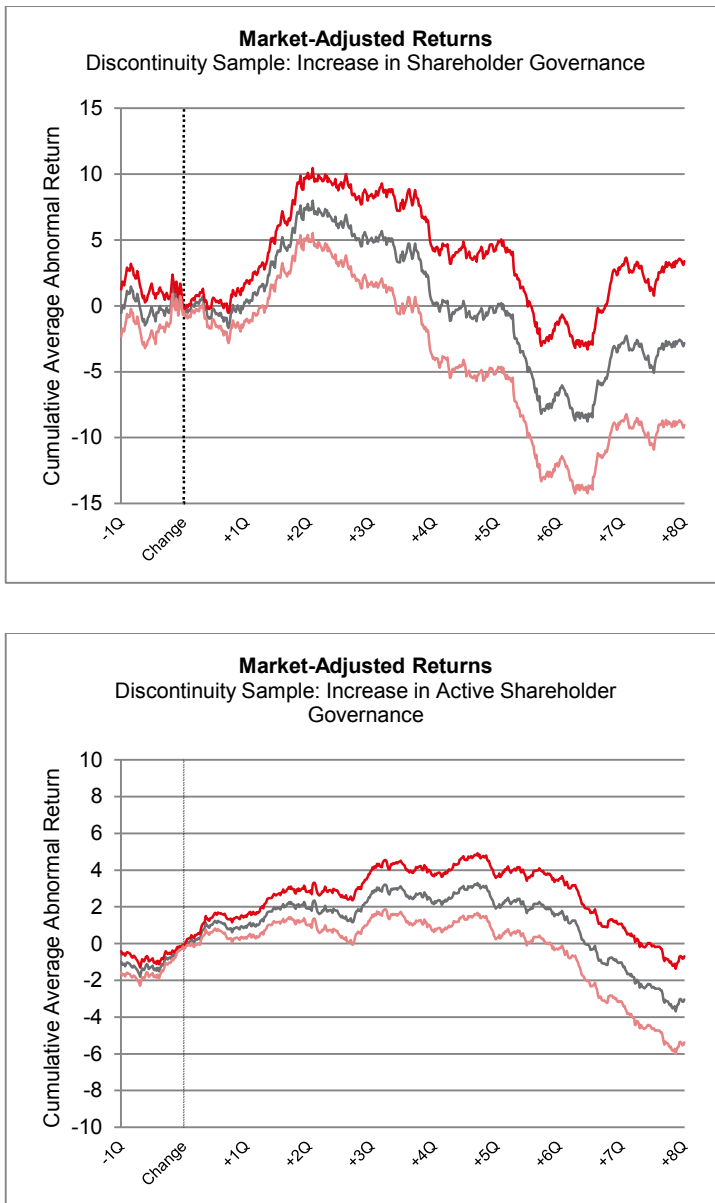
Popadak reports that in companies where the propositions go through there are “statistically significant increases in results-orientation and statistically significant decreases in customer-orientation, integrity, and collaboration. This suggests that following an increase in shareholder governance, managers implement processes which lead employees to believe that performance and achievement are the appropriate response to unforeseen contingencies even if this involves sacrificing honesty, ethics, and teamwork.” Popadak finds that in the short term the results orientation brings financial gains but these are quickly reversed (Figure 2.2). “Specifically, in the year of the change in corporate culture, increases in sales, profitability, and payout occur but in the long term of up to five years there are decreases in both intangible assets and customer satisfaction along with increases in goodwill. By the end of the third year, the tangible gains in sales and profitability erode and the intangible losses dominate.” Short-term financial gains are therefore pursued even if they undermine the firm's long-term best interest.

⁶⁵ Wolf, M. (26 August 2014) 'Opportunist shareholders must embrace commitment', *Financial Times*.

⁶⁶ See, for example, Kotter, J. and Heskett, J. (2011) 'Corporate Culture and Performance'; Free Press.

⁶⁷ Popadak, J. (2013) 'A Corporate Culture Channel: How Increased Shareholder Governance Reduces Firm Value'.

Figure 2.2: Market-adjusted returns following an increase in shareholder governance and change in corporate culture



Source: Popadak (2013)

Figure 2.2 shows abnormal equity returns – the difference between actual and expected returns – following an increase in governance around shareholder priorities. The top chart employs a “regression discontinuity approach” for a sample of S&P firms in which governance-related proposals were brought to a vote between 2005 and 2011 and fell within 10% of the passing threshold; the bottom chart employs an instrumental variable approach for a larger sample of firms over the same period. The central line represents the relative cumulative average abnormal returns and upper and lower lines represent the upper and lower 95% confidence intervals from a test of the difference.

between the increase in shareholder governance and non-increase in shareholder governance firms.(see footnote).⁶⁸

One example of where this happened was Sears Holdings in 2005 when hedge fund billionaire Eddie Lampert acquired a large position in the company. In the first year after the acquisition Sears' share price outperformed the market by 18%. Two years after, the shares had sunk 45% and sales retreated to pre-Lampert levels. In Britain an analogous example is British Home Stores decline and fall under Sir Philip Green's direction.⁶⁹ Similarly, ICI's precipitate demise had parallel roots. In 1987 it declared that its purpose was "to be the world's leading chemical company, servicing customers internationally through the innovative and responsible application of chemistry and related science. Through achievement of our aim we will enhance the wealth and well-being of our shareholders, our employees, our customers and the communities which we serve and in which we operate." By 1994 its purpose had been redefined as: "our objective is to maximise value for our shareholders by focusing on businesses where we have market leadership, a technological edge and a world competitive cost base."⁷⁰ The company had made an overt change in its stated priorities in response to a large shareholder, Hanson Trust, building a significant holding to address the unevenness of performance reflecting its antecedents as a merged entity. In ICI's case the intervention was to lead to the break up of the company, with one part merging to form the pharmaceutical company AstraZeneca and the other being taken over by AKZO.

This is not to suggest in any way that the effects of stronger shareholder rights or governance are necessarily detrimental. For example, Cunat et al (2012) find that votes narrowly cast in shareholder meetings in favour of propositions that remove anti-takeover provisions yield significant positive returns to shareholders.⁷¹ These gains are associated with falls in company acquisitions and capital expenditures, which the authors interpret as suggesting that increasing managerial discipline discourages value-diminishing investments. However, their results are also consistent with managerial autonomy being conducive to greater corporate investment. No doubt there are firms with such a poor focus on results, engaging in value destroying investments with few intangible assets, that increased shareholder governance has enduring pay-offs for them. However, there are others for which, excessive shareholder pressure has adverse effects on their corporate culture and long-term value creation.⁶⁵

⁶⁸ This permits causal inferences by finding an instrument i.e. variation in portfolio diversification, that is correlated with the explanatory variable of interest i.e. shareholder primacy but is uncorrelated with the outcome of interest i.e. corporate culture or other omitted variables. The assumption is that investors with less diversified portfolios apply more active governance and only affect corporate culture through this channel.

⁶⁹ Ford, J. (3 April 2016) 'BHS: A Dealmaker's Debacle', *Financial Times*.

⁷⁰ Kay, J. (2015) 'Other People's Money: Masters of the Universe or Servants of the People?'; Profile Books.

⁷¹ Cunat, V., Gine, M. and Guadalupe, M. (2012) 'The Vote Is Cast: The Effect of Corporate Governance on Shareholder Value', *Journal of Finance* 67, 1943–1977. The study uses a regression discontinuity design.

Implementing entrepreneurs' vision

Another function served by the firm is to enable the implementation of what Goshen and Hamdani describe as “idiosyncratic ideas.”⁷² These are ideas based on visions of the founders and entrepreneurs that are difficult to communicate to outside investors. Well-informed long-term owners can be highly beneficial.⁷³ However, placing control in the hands of uninformed investors may threaten the adoption of visionary innovations that are valuable to the company in the long-term. Instead, investors might in some circumstances be better off binding themselves to the mast of the entrepreneur and standing by their initial judgements.

Goshen and Hamdani illustrate this in the case of Henry Ford. “Ford did not invent the automobile, nor did he own any valuable intellectual property in the technology. He was competing with hundreds of other entrepreneurs attempting to create a ‘horseless carriage.’ Ford, however, had a unique vision regarding car production. The first firm that he founded, the Detroit Automobile Company, was controlled by investors. While Ford’s investors demanded that cars be immediately produced and sold, Ford insisted on perfecting the design prior to production, leading to delays, frustration on both sides, and the eventual shutdown of the firm by the investors. Ford’s second attempt, the Henry Ford Company, was also controlled by investors. Again, after designing a car, Ford resisted investors’ pressure and interference, and he did not move directly into production. Eventually, his obstinacy led to the investors replacing Ford with Henry Leland, changing the company name to the Cadillac Automobile Company, and producing the car designed by Ford with great success.

In his third attempt, the Ford Motor Company, Ford insisted on retaining control. This time, with no outside investor interference, Ford transformed his ideas for car design and production (his idiosyncratic value) into one of the great corporate success stories of all time. Finally, with yet another move along the spectrum of ownership structures, Ford’s grandson, Henry II, took the corporation public in 1956 with a dual-class share structure, ensuring that control stayed with the Ford family to this day.”

The capability to commit

In both the case of a unified purpose and common culture and the promotion of idiosyncratic ideas, companies need to be able to commit to what in the short-term may appear to be value diminishing but are in the long-run value enhancing policies. A variety of mechanisms

⁷² Goshen, Z. and Hamdani, A. (2016) ‘Corporate Control and Idiosyncratic Value’, *Yale Law Review* 125, 560–617.

⁷³ Where management’s idiosyncratic value is sufficiently large, it may simply launch a management buyout (MBO), with management owning control and cash-flow rights and investors providing debt. See Kaplan, S. (1989) ‘The Effect of Management Buyouts on Operating Performance and Value’, *Journal of Financial Economics* 24, 217–254. This is an example of how a large informed shareholder can be beneficial.

exist that allow companies to do this. While the UK and the US are frequently categorised together as Anglo-American systems, to contrast them with those of Continental Europe and Asia, the differences between the two countries are as great as their similarities. The US has numerous commitment mechanisms: dual-class share structures, staggered boards and 'poison pill' defences against contested takeovers, which do not exist in the UK.

Whether these commitment devices achieve what they purport to do is ultimately an empirical question. Much of the evidence is highly sceptical. As an example, one popular approach in the US is the use of antitakeover statutes. To identify causal effects, empirical studies exploit a natural experiment – the passage of state-level business combination (BC) statutes that increase a firm's protection from unsought takeover bids.⁷⁴ Because firm-specific considerations tend to drive the choice of governance arrangements, this addresses the concern that other factors or characteristics may influence or be correlated with the business outcome under examination.⁷⁵ By contrast, since legislative changes are outside the control of individual firms and are passed in the state of incorporation rather than the state of location, which could be influenced by local economic conditions, they provide a precise identification of the effects of takeover protections in relation to firms that are not covered by them.

With few exceptions, these studies have cast doubt on the effectiveness of takeover protections. Bertrand and Mullainathan who pioneered this approach find that firms incorporated in states that pass BC statutes pay higher wages but are less likely to close down old plants or create new ones. Their explanation is that executives, insulated from market discipline, prefer to enjoy the 'quiet life', avoiding difficult decisions and buying peace from the workforce, with costs for plant-level productivity and profitability: specifically the introduction of antitakeover legislation results in a roughly 0.8% drop in return on capital.⁷⁶

A second example is staggered boards. The battle over staggered boards in which the composition of boards can only be changed gradually over an extended period of time has assumed particular significance. Staggered boards have been high on the agenda of

⁷⁴ These statutes impose a moratorium (3–5 years) on large asset sales and mergers between a large shareholder and the firm after the shareholder's stake passes a predetermined threshold. For robustness, these studies also examine other aspects of this legislation, including fair price and control share acquisition statutes, though business combination statutes are viewed as providing the strongest protection.

⁷⁵ For general evidence that firm-specific considerations drive the choice of governance arrangements, see Adams, R., Hermalin, B. and Weisbach, M. (2010) 'The Role of Boards of Directors in Corporate Governance: A Conceptual Framework and Survey', *Journal of Economic Literature* 48, 58–107.

⁷⁶ Bertrand, M. and Mullainathan, S. (2003) 'Enjoying the Quiet Life? Corporate Governance and Managerial Preferences', *Journal of Political Economy* 111, 1043–1075. Other studies reporting similar results are Giroud, X. and Mueller, H. (2010) 'Does Corporate Governance Matter in Competitive Industries?', *Journal of Financial Economics* 95, 312–331. They find operating performance as measured by ROA drop, especially in noncompetitive industries. See also Atanassov, J. (2013) 'Do Hostile Takeovers Stifle Innovation? Evidence from Antitakeover Legislation and Corporate Patenting', *Journal of Finance* 68, 1097–1131. It finds that innovation activity, as measured by patents and patent citations decrease by 11% and 16% respectively, though this effect is virtually eliminated by the presence of a blockholder, notably oversight from public pension funds. For an overview of this literature, see Table A1 in Karpoff, J. and Wittry, M. (2015) 'Institutional and Political Economy Considerations in Natural Experiments'; Working Paper.

shareholder rights activists and corporate governance rating agencies.⁷⁷ As a result, the proportion of S&P 500 companies with staggered boards has fallen from 60% in 2000 to only 12% in 2013, leading Leo Strine, the Chief Justice of the Delaware Supreme Court, to remark that staggered boards have become an “endangered species”.⁷⁸

Findings from cross-sectional studies have largely validated this collective drive, presenting staggered boards as harmful to firm value. One study finds staggered boards reduces Tobin’s Q a measure of firm value, by 3 to 4%, with effects stronger for staggered boards established in the corporate charter than the company’s bylaws that cannot be amended by shareholders.⁷⁹

The above studies have been challenged, however. Karpoff and Wittry (2015) and Catan and Kahan (2016) show that focusing solely on BC statutes at the expense of wider institutional, political economy and historical conditions can lead to bias and even reverse interpretations.⁸⁰ They find that for a range of firm outcomes examined in prior studies the effect of BC statutes becomes insignificant once controls are added.⁸¹ Likewise, in regard to staggered boards, Cremers, Litov and Sepe⁸² find that cross-sectionally firms with staggered boards have lower firm value in line with previous research. However when they use time-series analysis they find that staggered boards are positively related to firm value, on average, adoption of a staggered board being associated with an increase in firm value of 6.9%.⁸³

This is an advance on the identification methods of previous staggered board studies,

⁷⁷ In the last decade, shareholder proposals to destagger have outnumbered any other shareholder proposal submitted at US companies.

⁷⁸ Strine, L. (2014) ‘Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law’, *Columbia Law Review* 114, 449–502.

⁷⁹ Bebchuk, L. and Cohen, A. (2005) ‘The Costs of Entrenched Boards’, *Journal of Financial Economics* 78, 409–433. See also Faleye, O. (2007) ‘Classified Boards, Firm Value, and Managerial Entrenchment’, *Journal of Financial Economics* 83, 501–529.

⁸⁰ Catan, E. and Kahan, M. (2016) ‘The Law and Finance of Antitakeover Statutes’, *Stanford Law Review* 68, 629–680; Karpoff, J. and Wittry, M. (2015) ‘Institutional and Political Economy Considerations in Natural Experiments’, Working Paper. For the use of regulatory and legal changes as a natural experiment, see Besley, T. and Case, A. (2000) ‘Unnatural Experiments? Estimating the Incidence of Economic Policies’, *The Economic Journal* 110, 672–694 and Werner, T. and Coleman, J. (2015) ‘Citizens United, Independent Expenditures, and Agency Costs: Reexamining the Political Economy of State Antitakeover Statutes’, *Journal of Law, Economics and Organization* 31, 127–159.

⁸¹ In replications poison pills are found to be economically and statistically significant which chimes with the importance attached to them by legal scholars, see Karpoff, J. and Wittry, M. op. cit.

⁸² See Cremers, M., Litov, L. and Sepe, S. (2015) ‘Staggered Boards and Firm Value, Revisited’, Working Paper and Cremers, M. and Sepe, S. (2016) ‘The Shareholder Value of Empowered Boards’, *Stanford Law Review* 68. Time series analysis can control for firm characteristics that do not change over time; as such, it is better equipped to isolate what change in firm value within the same firm occurred before or after the adoption of a staggered board and thus rule out reverse causality which is found to drive cross-sectional results.

⁸³ In establishing this association, the authors rule out a number of alternative explanations: they find no evidence that the valuation effects of adopting a staggered board are driven by expectations of future takeover activity that often produce substantial premia for the target’s shareholders. Nor do they find that the adoption is accompanied by other changes in firm governance that toughen safeguards against managerial entrenchment – and so amply compensate shareholders for the costs of staggered boards.

though it still falls short of direct causality. A study by Cohen and Wang provides stronger inferences in this regard.⁸⁴ It investigates two Delaware court decisions in the Airgas case which had diverging impacts on companies with staggered boards, depending on the random timing of a company's annual meeting. Measuring announcement returns after these two rulings, the authors find evidence consistent with the view that staggered boards reduce stock price, albeit not at conventional levels of significance.⁸⁵

All this suggests caution should be applied when evaluating evidence on antitakeover statutes and staggered boards. Most significantly of all they suggest that treating firms as homogenous entities may miss interesting patterns at a granular level. For instance, Johnson, Karpoff and Yi report that initial public offering companies (IPOs) employ more takeover defences such as staggered boards when they have important business partnerships – large customers, dependent suppliers, or strategic alliance partners – to protect.⁸⁶ In the absence of such defences those partnerships could be threatened by possible takeovers of the IPO firms. Consistent with this, they find a positive association between these defences and subsequent valuation and operating performance.⁸⁷ Others find that these protections matter more to companies that rely on R&D and intangibles⁸⁸, operate in opaque information environments⁸⁹ and have higher advisory needs⁹⁰ – settings which are consistent with the importance of commitment. Acquisitions financed with debt or takeovers that result in a significant increase in market power may be especially disruptive.⁹¹

⁸⁴ Cohen, A. and Wang, C. (2013) 'How do Staggered Boards Affect Shareholder Value? Evidence from a Natural Experiment', *Journal of Financial Economics* 110, 627–641. For a study that sheds light on causality via RD and IV techniques but finds that adopting antitakeover provisions increases shareholder value by approximately 5%, see Smith, E. (2015) 'Do Shareholders Want Less Governance? Evidence from the Adoption of Antitakeover Provisions'; Working Paper.

⁸⁵ The quasi-experimental design employed by this study has many appealing features, though it leaves a number of unanswered questions. First, as with all event studies that focus on short-term market reactions, it says little about long-term effects of staggered boards on firm fundamentals. Second, as others have pointed out, findings appear quite sensitive to sample selection, the removal of outliers and the choice of different industry fixed effects. See Amihud, Y. and Stoyanov, S. (2016) 'Do Staggered Boards Harm Shareholders'; Working Paper. See also Cremers and Sepe op cit. Third, insofar as existing Delaware law permits the use of powerful antitakeover protections such as poison pills, it is not possible to determine whether having annual elections for directors would generate greater shareholder value than having staggered boards but with restrictions on takeover defences such as poison pills. Thus, it provides limited real-world guidance to firms contemplating the adoption of a staggered board outside a takeover context where even sceptics acknowledge the intellectual case is strongest. See Subramanian, G. (14 February 2007) 'Board Silly', *New York Times*. Finally, it speaks only to the average effect of staggered boards; it is possible that staggered boards will have different effects for different firms.

⁸⁶ Johnson, W., Karpoff, J. and Yi, S. (2015) 'The Bonding Hypothesis of Takeover Defenses: Evidence from IPO Firms', *Journal of Financial Economics* 117, 307–332.

⁸⁷ This association continues to hold when the authors use the identity and characteristics of the IPO company's law firm to instrument for takeover defences, supporting the inference that takeover defences are a cause of, not just correlated with higher value and performance.

⁸⁸ Cremers, M., Litov, L. and Sepe, S. (2015) and Cremers, M. and Sepe, S. (2016) op cit.

⁸⁹ Duru, A., Wang, D. and Zhao, Y. (2013) 'Staggered Boards, Corporate Opacity and Firm Value', *Journal of Banking and Finance* 37, 341–360.

⁹⁰ Ahn, S., Goyal, V. and Shrestha, K. (2013) 'The Differential Effects of Classified Boards on Firm Value', *Journal of Banking and Finance* 37, 3993–4013.

⁹¹ Cen, L., Dasgupta, S. and Sen, R. (2015) 'Discipline or Disruption? Stakeholder Relationships and the Effect of Takeover Threat', *Management Science*; Forthcoming.

There is also evidence that value effects depend on industry structure. Kadyrzhanova and Rhodes-Kropf draw a distinction between defences that impose a delay on potential acquirers and ones that do not.⁹² They find that delay provisions such as staggered boards increase bargaining power by locking in shareholders, with effects strongest in concentrated industries where targets are relatively scarce. Similarly, defences may be complements with other organisational practices and features such as management quality.⁹³ Baranchuk, Kieschnick and Moussawi, for instance, find that long-term incentives combined with protection from early failure and/or takeover is supportive of innovation activity.⁹⁴

Finally, commitment devices need not take the form of traditional takeover protections. Flammer and Kacperczyk report the impact of state-level constituency statutes on innovation.⁹⁵ Under these statutes, a corporation's directors are permitted to incorporate a wide range of stakeholder interests in their business decisions. The authors find that after enactment, the number of patents increases significantly and over time so that after 48 months, the number of patents and citations increases by 8%, suggesting that stakeholder orientation has an enduring effect on innovation.

It is important to view these claims as suggestive rather than definitive and causal.⁹⁶ The flipside of acknowledging the importance of heterogeneous effects is that arrangements will not be appropriate in every circumstance. There are many companies in which stakeholder interests are adequately protected through contract or where the investments that these parties make in the firm are modest and in need of little protection. There are companies that do not invest heavily in intangibles and are not pursuing idiosyncratic visionary ideas of entrepreneurs and founders. Managers with a small opportunity set and few available resources may have limited scope to pursue idiosyncratic value.⁹⁷ Others may suffer from tunnel vision and overconfidence: the corporate landscape is littered with the husks of businesses and ideas that failed because entrepreneurs dug their heels in rather than

⁹² Kadyrzhanova, D. and Rhodes-Kropf, M. (2011) 'Concentrating on Governance', *Journal of Finance* 66, 1649–1685.

⁹³ Chemmanur, T., Paeglis, I. and Simonyan, K. (2011) 'Management Quality and Anti-Takeover Provisions', *Journal of Law and Economics* 54, 651–692.

⁹⁴ Baranchuk, N., Kieschnick, R. and Moussawi, R. (2014) 'Motivating Innovation in Newly Public Firms', *Journal of Financial Economics* 111, 578–588. These complementarities are consistent with theory: see Skeie, D. (2007) 'Vesting and Control in Venture Capital Contracts', *Staff Reports* 297; Federal Reserve Bank of New York and Manso, G. (2011) 'Motivating Innovation', *Journal of Finance* 66, 1823–1860. Manso finds that the optimal incentive scheme for innovation combines substantial tolerance, and even support for early failure, with reward for long-term success as well as timely feedback on performance. However, this should not be viewed as providing a general justification for tolerating managerial failure.

⁹⁵ Flammer, C. and Kacperczyk, A. (2015) 'The Impact of Stakeholder Orientation on Innovation: Evidence from a Natural Experiment', *Management Science*; Forthcoming. Note some of the problems described in relation to antitakeover statutes apply here e.g. the role of corporate lobbying and political economy considerations.

⁹⁶ Caution may be in order if only because many of the studies rely on cross-sectional evidence which is subject to potential misspecification and control problems.

⁹⁷ Wasserman, N., Anand, B. and Nohria, N. 'When does Leadership Matter: A Contingent Opportunities View of CEO Leadership', in Nohria, N. and Khuruna, R. (2010) *Handbook of Leadership Theory and Practice*; Harvard Business Press.

relinquish control and accept outside input.⁹⁸ In these instances, the costs of commitment devices may greatly outweigh their benefits. As with any complex human and commercial activity, there is a ledger of pluses and minuses and evidence that the net effect depends on the nature of and the context in which activities are being undertaken.

British particularities

Identifying the circumstances in which these devices benefit purpose constitutes a more fruitful line of inquiry than simply asking whether or not they are generically beneficial. In the UK, policy and precedent have foreclosed this approach. Instead attempts have been made to broaden the scope of director responsibilities through s.172 of the Company Act 2006 by recognising the interests of parties other than the shareholders. However, these are derivative responsibilities on directors subordinate to those of the owners of the company: they are not primary obligations to respect the interests of other stakeholders in their own right. Their effectiveness is further circumscribed by the courts' lack of business expertise and reluctance to second-guess the decisions or policies of directors, save in cases of very bad behaviour or where directors have left clear proof of their thought processes.⁹⁹ This outlook, enshrined in the business judgement rule, reflects the legal traditions of the common law system, which approaches issues from a perspective in which the contract predominates.¹⁰⁰

The upshot is that UK directors are not liberated from the pursuit of shareholder interests to nearly the same extent as the various forms of protection in the US. In the US, variants of dual class shares are commonplace and some of the most prominent companies have issued dual class shares (see Figure 2.3 and 2.4). Recent examples include Facebook, Google, LinkedIn and Under Armour, all of which came to the stock market with dual class shares that conferred substantially more voting rights on their founders than on investors who subscribed to public issues.

Figure 2.3: Anti-takeover provisions and prevalence of dual class shares in several industries in the US

Industry	Anti-Takeover Provisions	Dual-Class Shares
Apparel	18%	10%
Communication	17%	38%
Industrial Services	24%	10%
Metal, Plastics	34%	15%
Average All IPOs	22%	5%

⁹⁸ Wasserman, N. (2013) 'The Founder's Dilemmas: Anticipating and Avoiding the Pitfalls That Can Sink a Startup'; Princeton University Press.

⁹⁹ Davies, P. and Worthington, S. (2012) *Gower & Davies: Principles of Modern Company Law*; Sweet & Maxwell.

¹⁰⁰ Vasudev, P. 'Corporate Stakeholders in Canada – An Overview and a Proposal', *Ottawa Law Review* 45, 135–178.

Source: Laura Fields (1999)

Figure 2.4: Examples of dual class shares in the US

Google:

Class A common stock one vote per share
Class B 10 votes per share
Larry Page, Sergey Brin and Eric Schmidt 37.6% of votes; executive and directors 61.4%.

LinkedIn:

Class A common stock one vote per share
Class B 10 votes per share
Class B shareholders give to all pre-IPO investors Reid Hoffman 21.7% increasing over time.

Evidence on the impact of dual-class shares is relatively limited, though the most authoritative study to date by Gompers, Ishii and Metrick (2010) finds that companies with dual-class shares are more likely to have agency problems than those with a single share class. Firm value is negatively associated with the wedge between insiders' cash flow rights and voting rights which is large enough in many cases to provide insiders with a majority of the votes despite their claims to only a minority of the economic value.¹⁰¹ Again, this work is far from the final say: Gompers, Ishii and Metrick's own results are quite sensitive to sample selection and estimation methods used to address endogeneity concerns.¹⁰²

More importantly, the effectiveness of dual class shares, like other commitment devices, hinges on the details. There is growing attention to the ways in which dual class shares and other commitment devices are designed to deliver their purported benefits without giving rise to abuse or unintended consequences. These include the use of sunset clauses and conditionalities, vote caps, minimum equity thresholds held by insiders, open eligibility criteria, basic voting rights for common shares and a myriad of other features related to a company's governance.¹⁰³ This type of fine variation rarely shows up in the data and leaves open the possibility that intermediate or hybrid structures may be more beneficial for corporate performance.

¹⁰¹ Gompers, P., Ishii, J. and Metrick, A. (2010) 'Extreme Governance: An Analysis of Dual-Class Companies in the United States', *Review of Financial Studies* 23, 1051–1088.

¹⁰² In instrumental variable regressions, point estimates are similar but significance levels are much lower. Results are strongest for a particular subset of dual class firms – ones with voting control but less than 50% of the cash-flow rights, representing around 35–40% of the dual class universe.

¹⁰³ For statements of good practice, see the Canadian Coalition for Good Governance: http://www.ccg.ca/site/ccgg/assets/pdf/dual_class_share_policy.pdf. See also the Hong Kong Stock Exchange <https://www.hkex.com.hk/eng/newsconsul/mktconsul/Documents/cp2014082cc.pdf>. The exchange gave up on dual class shares after the Hong Kong Securities and Futures Commission (SFC) rejected it.

An important recent development, in this respect, is the principle of proxy access by which shareholders in a number of US companies, such as Apple, are being granted the right to put forward nominations to their board of directors in the companies' annual proxy statements if they or a group of (for example up to 20) shareholders have held more than a certain fraction of shares (e.g. 3%) for a particular period of time (e.g. 3 years). It thereby confers greater rights on blocks of shares held for long periods rather than on just company founders and other insiders. It is similar to such principles as the *Loi Florange* in France by which shareholders who have held their shares for more than two years automatically have the right to double voting rights unless the company specifically opts not to apply this. Italy has a similar law.

UK rules do not allow what are termed 'premium-listed companies' to issue any form of dual class shares that confer differential voting rights on different classes of shareholders. British regulatory authorities, along with institutional investors, believe that dual class shares however designed discriminate against minority shareholders who have fewer voting rights per share. They are therefore regarded as a violation of minority investor protection and equality of treatment of shareholders.¹⁰⁴ A second contrasting example is the powerful limit on the use of the staggered board. It is a mandatory rule of UK company law that shareholders can remove directors at any time by an ordinary resolution. A meeting to vote on such a resolution can be requisitioned by only 10% of the company's voting shares.

The contrast extends to the rules regarding the use of takeover defences by target firms of hostile acquisitions. American law allows companies to create blocking positions in the event of a hostile takeover by issuing new shares to existing shareholders but excluding those held by the acquirer. This poison pill defence dilutes the shares held by the acquirer making it prohibitively expensive for the acquirer to proceed with a bid. The target management is thus empowered to use its business judgement in determining whether an acquisition is in the best interests of shareholders as owners, or fails to reward them adequately for their shares should the takeover go ahead. The case against poison pills is that they can allow managements to entrench themselves and/or protect their own interests. In this territory there are very few if no initiatives that do not have some downsides to offset potential upsides!

The UK Takeover Code, which defines the rules by which takeovers are conducted, has been strengthened in the wake of Kraft's takeover of Cadbury. Put-up-or-shut-up requirements, greater recognition of employee interests, improved transparency of bidders' plans and increased clarity over post-offer commitments have put the interests of long-term investors and stakeholders on a more solid footing. However, these changes are still seen as a halfway house and unlikely to alter the incentives or behaviour of a bidder that is intent on parking its tanks on the target company's lawn.¹⁰⁵ Moreover takeover regulation has long

¹⁰⁴ Stapledon, G. (1996) 'Institutional Shareholders and Corporate Governance'; Oxford University Press.

¹⁰⁵ Thanks to Mark Seligman for his commentary on the nature and impact of post-Cadbury Takeover Code.

leaned against the American view and stipulates that a target of an acquisition cannot adopt poison pills once a takeover bid has been initiated. Management is not granted similar discretion, the reason being that poison pills are regarded as a way of frustrating value-enhancing bids against the interests of minority shareholders. This particular concern is not without justification though it is emblematic of the general way in which UK regulation restricts the ability of founders to retain control of companies after they are listed on stock markets and limits management's freedom to defend themselves against hostile acquisitions. It has thereby contributed significantly to the dispersed nature of ownership of its listed companies that we describe in Chapter 3 and to the unusually high level of exposure of companies to hostile takeovers. Between 1991 and 2005 hostile takeovers in Britain enjoyed a 61% success rate – far higher than elsewhere.¹⁰⁶ Nor have successive UK governments chosen to offset the bias, declaring that only in exceptional cases are they prepared to contest 'market' judgements.

The biases in Britain cumulatively lean against Purpose. Limitations on dual class shares, staggered boards and anti-takeover devices are viewed as important forms of minority investor protection with founders and managers not afforded the discretion the US confers on them to adopt what they regard as appropriate ownership structures. Notwithstanding its imperfections, what marks out the US and is a significant source of its corporate success is its diversity and promotion of a variety of forms of ownership and control. The UK is a much more uniformly shareholder oriented system that has restricted the way in which firms can structure their operations. It is this that lies at the heart of the de-purposing of the British economy and the malaise that we will document later. There may be considerable advantages to promoting and celebrating corporate diversity and facilitating it through enabling permissive regulation and legislation, not prescribing what a particular school of thought dictates as being the right way of structuring firms. To the extent purpose matters, this bias needs redressing.

Conclusion

Companies were originally established to embody purpose and for good reason. Markets cannot substitute for organisations with purpose. They are complementary, not substitutes. For companies to be able to deliver on purpose they need to be able to commit to it and establish the internal cultures that are consistent with it. Shareholder primacy has made clear where the power of organisations ultimately lies. It is not with CEOs, chairmen or boards of directors. These are agents; they are not the principals. Whatever the good intention of the management, however compelling the purpose statements of companies, if the shareholders are not committed to them, they are of little significance.

In some cases, this is justified by the need to align management with shareholder interests. In others management needs to be able to stand back and take a more balanced view of

¹⁰⁶ Ford, J. (2014) 'A new approach to British deal making is required', <http://www.ft.com/cms/s/0/3a8a12a6-f14c-11e3-9fb0-00144feabdc0.html>

what is in the corporate interest as a whole. They need to be able to commit to the community of interests in the firm including those promoting idiosyncratic ideas that are the source of corporate innovation and value creation in the long-run. This may involve constraining the power of shareholders.

This is not to suggest that shareholder rights should be diminished in all circumstances but that companies should have greater latitude in determining what is suited to their particular activities. Diversity should be welcomed and encouraged through regulation that is enabling and permissive rather than prescriptive and restrictive, with policies that we discuss in Chapter 5. The UK has not been wrong to strengthen shareholder rights but it has erred in seeking its uniform adoption. The next chapter will document the implications of this for the distinctive form of ownership that has emerged in the UK.

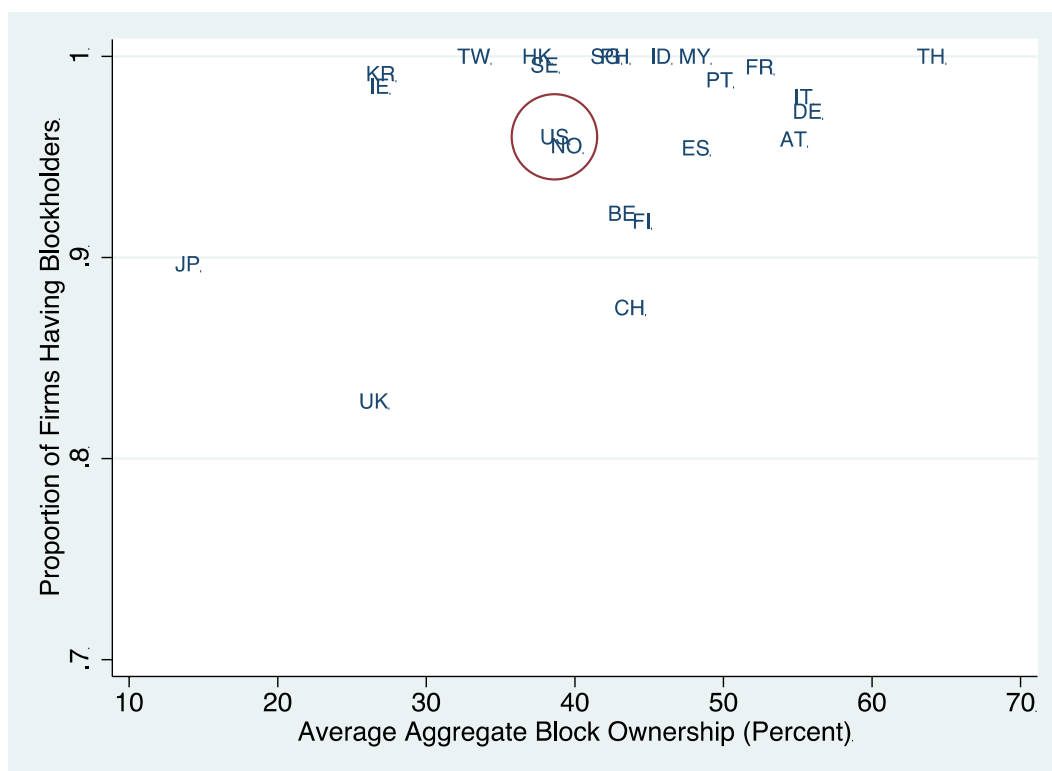
3. Ownership and purpose

British public companies have a uniquely diversified, fragmented shareholder base, and engaged long-term shareholders are very much in a minority. There is a tension, as argued in the previous chapter, between shareholder-as-investor assessing a company purely in its capacity to deliver immediate financial returns and shareholder-as-owner, encouraging the company to express purpose over time and so create sustained value. Engaged owners have an interest in promoting, protecting and preserving the company and are ready to spend the time and resource in gathering the information they need to monitor it, having an iterative dialogue with the management. At the same time even committed owners sometimes need to sell as if they were investors. This ability is no less fundamental to share ownership. Shareholders need to know their investment is liquid. Moreover this threat of selling, or exiting, is not always malign: it also can act as an important disciplinary impact on managements.

The task is to balance the twin impulses in shareholding between investing and engaged ownership. Britain enforces the view, as we showed earlier, in its approach to law and regulation that all shareholders are equal, taking no heed of this tension. This would matter less if share ownership in Britain were more concentrated, so that company managers could look to a few committed owners to engage with them over time. But such block shareholders are conspicuous by their absence. It is this combination of a highly fragmented shareholder base with lack of block shareholders but where all shareholders are equally empowered that produces the very particular over-prioritisation of shareholder/investor concerns over purpose that characterises British business. In Chapter 4 we will show in detail how that has hurt both companies and the wider economy. This chapter will discuss the structure of share ownership, and the character and incentives of the institutional owners of British shares.

Comparison with Continental European and Asian economies but also in relation to the US shows how unusual Britain is in not having a critical mass of shareholders capable of acting as owners who can anchor the company and its purpose. The figure below shows on the y-axis the proportion of firms having an owner of a block of at least 5% of the shares in a company – what will be referred to below as ‘blockholders’ – and on the x-axis the average size of the blocks of shares held by these blockholders. It shows the UK in the bottom left-hand side of the diagram as an outlier in terms of the small proportion of companies with blockholders and the small average size of those blocks, even in comparison with the US where there are significantly more and larger blocks of shares.

Figure 3.1: Large-block common stock ownership at public corporations in the United States and 22 other countries



Source: Holderness, 2009.¹⁰⁷ scatter presents large-block common stock ownership for 23 countries around the world. X-axis is the country average of the aggregate per cent common stock ownership of all shareholders in a firm who own at least 5% of the voting power of the common stock. If a firm has no blockholders, the firm is included in the country average at zero. Y-axis is the proportion of firms within a given country that have at least one blockholder. Blockholders are those shareholders who own at least 5% of the voting power of the common stock.

In the absence of significant blockholders, there are fewer shareholders in the UK who have the interest and resource to gather costly information about the companies in which they invest, and then help monitor and govern them, than in virtually any other major industrialised country. With fragmented ownership, companies are afflicted by a problem of free riding on corporate governance. Institutions and individuals hold diversified portfolios that provide little incentive for them to monitor the performance of any individual stock in their portfolios.

There are a growing number of active shareholders in Britain – but in many cases they struggle to engage meaningfully with companies as owners. There is an even larger number of long-term investors, most notably index funds (constituting some 12% of shareholding and growing) – but there are limits to what they can achieve on their own, notwithstanding a

¹⁰⁷ Holderness, C. (2009) 'The Myth of Diffuse Ownership in the United States', *Review of Financial Studies* 22, 1377–1408.

growing recognition of the importance of their stewardship obligations.

Blockholders, on the other hand, have the incentives and ability to engage in governance, due to their large stakes.¹⁰⁸ There are two ways in which blockholders perform this function. The first is ‘voice’ – direct intervention such as advising the manager on a restructuring, using their business contacts to benefit the firm, or blocking pet projects. For example, the Hermes Focus Fund engaged in private interventions with management; when these engagements were successful, they led to an average increase in firm value of 5%.¹⁰⁹ Similar results were found for TIAA-CREF, a large U.S. pension fund.¹¹⁰

The second governance mechanism is ‘exit’. If the manager underperforms or is delivering high short-term earnings at the expense of purpose and long-run value, blockholders can sell their shares, reducing the stock price and thus punishing the manager.¹¹¹ The threat of exit induces the manager to improve firm value, though the credibility of this threat will vary from setting to setting.¹¹² One concern with ‘exit’ is that, if an investor sells shares based on short-term earnings, this pressures managers to focus on earnings rather than long-run value. However, earnings are public information and immediately incorporated into the stock price. There is little motive to sell a firm after it has delivered low earnings, as its price has already dropped. Instead, blockholders, whether they engage in ‘voice’ or ‘exit’, have the incentive to gather costly intangible information about a company rather than just relying on freely-available earnings – analyse the satisfaction of its customers, corporate culture, business strategy, and innovative capability.¹¹³

Due to their large stakes, blockholders give managers the confidence to ‘swing for the fences’ and innovate: they understand why managers are taking the risks they are – especially true of risky frontier innovation where it is particularly hard for disengaged arms-length investors to differentiate between a lack of skill and an unlucky break. Indeed, there is evidence that blockholders trade on long-term information, and that their trading imposes discipline on management and puts information into prices.¹¹⁴ Consistent with both voice and

¹⁰⁸ Edmans, A. (2014) ‘Blockholders and Corporate Governance’, *Annual Review of Financial Economics* 6, 23–50.

¹⁰⁹ Becht, M., Franks, J., Mayer, C. and Rossi, S. (2009) ‘Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund’, *Review of Financial Studies* 22, 3093–3129.

¹¹⁰ Carleton, W., Nelson, J. and Weisbach, M. (1998) ‘The Influence of Institutions on Corporate Governance through Private Negotiations: Evidence from TIAA-CREF’, *Journal of Finance* 53, 1335–1362.

¹¹¹ Admati, A. and Pfleiderer, P. (2009) ‘The Wall Street Walk and Shareholder Activism: Exit as a Form of Voice’, *Review of Financial Studies* 22, 2645–2685.

¹¹² See Table IV in McCahery, J., Sautner, Z. and Starks, L. (2016) ‘Behind the Scenes: The Corporate Governance Preferences of Institutional Investors’, *Journal of Finance*; Forthcoming. See also Dasgupta, A. and Piacentino, G. (2015) ‘The Wall Street Walk When Blockholders Compete for Flows’, *Journal of Finance* 70, 2853–2896 arguing that when asset managers compete for short-term investor flows and exit is seen as a signal about blockholder stock selection ability, the threat of exit loses credibility, diminishing its governance role.

¹¹³ Edmans, A. (2009) ‘Blockholder Trading, Market Efficiency, and Managerial Myopia’, *Journal of Finance* 64, 2481–2513.

¹¹⁴ Parrino, R., Siais, R. and Starks, L. (2003) ‘Voting With Their Feet: Institutional Ownership Changes around Forced CEO Turnover’, *Journal of Financial Economics* 68, 3–46; Brockman, P. and Yan, X. (2009) ‘Block Ownership and Firm-Specific Information’, *Journal of Banking and Finance* 33, 308–316.

exit mechanisms, blockholders are associated with higher R&D expenditure¹¹⁵, innovation¹¹⁶ and firm performance.¹¹⁷

In sum, blockholders are important promoters of corporate purpose. Through their roles as monitors and custodians of corporate purpose, blockholders provide a public good to other investors. They act as what is sometimes termed ‘institutions of trust’, upholding the interests of minority investors. This has now been documented in many countries around the world over long periods of time.¹¹⁸

Blockholding, however, is not a universal panacea: as with any phenomenon there are downsides and trade-offs. As regulators argue, they can exploit their dominance to the detriment of minority investors by, for example, tunnelling profits out of subsidiaries that are part of wider groups of firms. The short-term gains from engaging in such practices might outweigh longer-term reputational or capital raising costs. For examples, studies that examine the price at which blocks of shares trade frequently report substantial premia over and above the market price at which minority shareholdings trade, implying significant private benefits, though these not be at the expense of other shareholders – for instance, where there are production synergies with another company controlled by the blockholder.¹¹⁹ In addition, blockholders may undermine the performance of their investments by intervening excessively in their management.¹²⁰ Nor is blockholding a substitute for good governance: the best results come when a firm has governance structures in place on which the blockholder can build.¹²¹

Both the size and identity of the blockholder matter in relieving some of these tensions. A blockholder can have too large a stake so that its interests become entrenched – or too small so there is inadequate heft. Thus, multiple small blockholders may be more effective

¹¹⁵ Baysinger, B., Kosnik, R. and Turk, T. (1991) ‘Effects of Board and Ownership Structure on Corporate R&D Strategy’, *Academy of Management Journal* 34, 205–214.

¹¹⁶ Aghion, P., Van Reenen, J. and Zingales, L. (2013) ‘Innovation and Institutional Ownership’, *American Economic Review* 103, 277–394; and Lee, P. (2005) ‘A Comparison of Ownership Structures and Innovations of U.S. and Japanese Firms’, *Managerial and Decision Economics* 26, 39–50.

¹¹⁷ See, for example, Ekholm, A. and Maury, B. (2014) ‘Portfolio Concentration and Firm Performance’, *Journal of Financial and Quantitative Analysis* 49, 903–931.

¹¹⁸ Franks, J., Mayer, C. and Rossi, S. ‘Spending Less Time with the Family: The Decline of Family Ownership in the UK’ in Morck, R. (ed) (2005) *A History of Corporate Governance Around the World*; University of Chicago Press; Franks, J., Mayer, C. and Rossi, S. (2009) ‘Ownership: Evolution and Regulation’, *Review of Financial Studies* 22, 4009–40; Franks, J., Mayer, C. and Miyajima, H. (2014) ‘The Ownership of Japanese Corporations in the 20th Century’, *Review of Financial Studies* 27, 2580–2625; and Franks, J., Mayer, C. and Wagner, H. (2006) ‘The Origins of the German Corporation: Finance, Ownership and Control’, *Review of Finance* 10, 537–585.

¹¹⁹ Albuquerque, R. and Schroth, E. (2010) ‘Quantifying private benefits of control from a structural model of blocktrades’. Barclay, J. and Holderness, C. (1989) ‘Private Benefits from Control of Public Corporations’, *Journal of Financial Economics* 25, 371–95. Indeed, block trades that occur at a premium to the postannouncement exchange price (thus implying private benefits of control) also lead to an increase in the stock price. This result suggests that private benefits either are not at the expense of shareholders or are outweighed by the governance benefits. See Barclay, M. and Holderness, C. (1992) ‘The Law and Large-block Trades’, *Journal of Law and Economics* 35, 265–94.

¹²⁰ Burkart, M., Gromb, D., and Panunzi, F. (1997) ‘Large Shareholders, Monitoring, and the Value of the Firm’, *Quarterly Journal of Economics* 112, 693–728.

¹²¹ Cremers, M. and Nair, V. (2005) ‘Governance Mechanisms and Equity Prices’, *Journal of Finance* 60, 2859–2894.

than one large blockholder, since the threat of exit is stronger.¹²² Very large stakes may cause the blockholder to worry about firm-specific risk – that is, having too many eggs in one basket: it may persuade the firm to forgo risky, value-creating investments.¹²³ Large blocks can also make it more difficult to profit on monitoring and engagement activities: a blockholder may not be able to sell its entire stake upon a negative signal because the price impact would be too high.¹²⁴ All this suggests that there are trade-offs in terms of the size of blockholdings such that multiple, small blockholders may be more effective than one large blockholder. Interestingly the US tends to have smaller blockholders, thus avoiding the dangers of too large blockholder stakes.

Identity matters too. Most of the positive evidence we have cited springs from external blocks held by shareholders not affiliated with management. Large, affiliated stockholders who are outsiders but have potential business ties to a firm are less effective monitors than other outside unaffiliated blockholders.¹²⁵

However, this does not necessarily mean that even such ‘good’ blockholders should remain with the firm for the long-term in all cases. A blockholder who remains with the firm, even if it destroys long-run value or engages in corporate malfeasance, is too affiliated with management to be effective. Indeed, Institutional Shareholder Services said that “a rise in the number of stable investors could lead to overly cosy relations between the company and its shareholders.” Volkswagen’s blockholders were a large insider family and the State of Lower Saxony, which led to management being entrenched and failed to deter the emissions scandal. (See Figure 3.2 below)

¹²² Edmans, A. and Manso, G. (2011) ‘Governance through Intervention and Trading: A Theory of Multiple Blockholders’, *Review of Financial Studies* 24, 2395–2428. Edmans, A., Levit, D. and Reilly, D. (2016) ‘Governing Multiple Firms’; Working Paper.

¹²³ Faccio, M., Marchica, M. and Mura, R. (2011) ‘Large Shareholder Diversification and Corporate Risk-Taking’, *Review of Financial Studies*.

¹²⁴ Edmans, A. (2009) ‘Blockholder Trading, Market Efficiency, and Managerial Myopia’, *Journal of Finance* 64, 2481–2513.

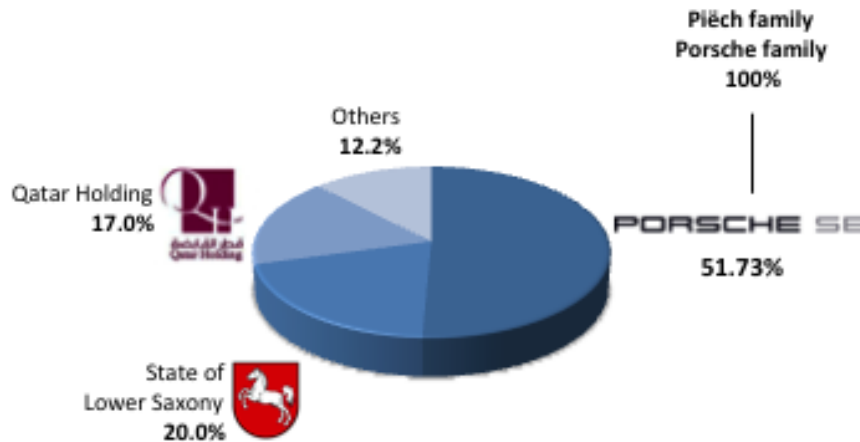
¹²⁵ This finding is also supported by a study comparing how markets react to the unexpected deaths of insider blockholders. See Borokhovich, K., Brunarski, K., Harman, Y. and Parrino, R. (2006) ‘Variation in the Monitoring Incentives of Outside Stockholders’, *Journal of Law and Economics* 49, 651–80.

Figure 3.2



*"We bear responsibility for continuous improvement of the environmental tolerability of our products and for the lowering of demands on natural resources while taking economic considerations into account.
At all of our locations, we are a partner to society and politics with respect to the configuration of social and ecologically sustainable positive development.
Each of our employees make appropriate and economical use of natural resources and ensure that their activities have only as limited an influence on the environment as possible."*

OWNERSHIP



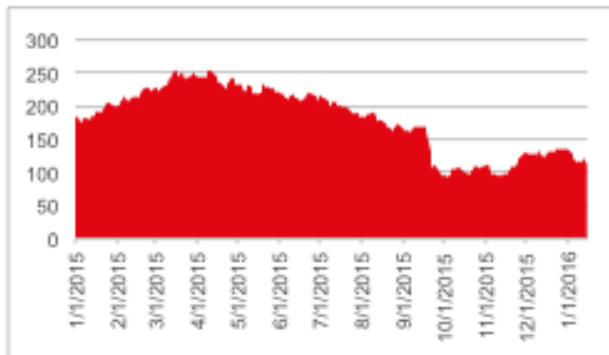
THE PRESIDIUM

Executive committee of the supervisory board

- Chairman / Ferdinand K. Piëch (continues in Porsche SE board) - resigned 04'15
- Hans D. Pötsch (group CFO) - appointed 10'15
- Deputy Chair/ Berthold Huber (IG Metall Union) - resigned 11'15
- Jörg Hofmann (IG Metall Union) - appointed 11'15

- Bernd Osterloh (employee representative)
- Dr. Wolfgang Porsche (chairman of Porsche SE)
- Stephan Weil (prime minister of the state of Lower Saxony)
- Stephan Wolf

CORPORATE SOCIAL RESPONSIBILITY AND TRANSPARENCY QUESTIONED



Volkswagen AG (VOW.DE) share price

- September 3, 2015 Volkswagen admit use of forbidden software to the US Environmental Protection Agency.
- September 20, 2015 knowing falsification of emission measures announced in public.
 - Lower Saxony state governor Stephan Weil - presidium member - learns of the scandal by reading the newspaper.
 - Stock trading continued 17 days after the private admission of fault undisturbed. On public admission of fault share price drops 37.11%.
- September 23, 2015 CEO Winterkorn resigns.
- September 25, 2015 Porsche chief Matthias Müller appointed as group chief executive.
- October, 2015 Appointment of Group CFO Pötsch to Supervisory board confirmed despite concerns on lack of transparency in publishing details of the emissions case.

Hedge funds as blockholders

The rise of hedge fund activists, which have aroused public controversy because of their aggressive tactics, can alternatively be viewed as a variant of blockholding. Many commentators express the concern that such hedge funds pursue short-term profit and financial engineering at the expense of long-term value; however, results have begun to challenge some of these preconceptions. The first landmark study of hedge fund activism¹²⁶ found that the announcement of activism leads to a 7% increase in firm value, with no reversal in the subsequent year. A follow-up study¹²⁷ analysed the sources of the operating gains, and found an increase in plant-level productivity. Working hours do not increase and wages do not fall, so the productivity increases are not based on sweating assets or wealth transfers from other stakeholders.¹²⁸

Nonetheless, not all types of activism are equally beneficial. A large-scale study from 23 countries finds that activism generates only trivial or no shareholder value when they involve changes in the board structure or the payout policy and are not accompanied by a restructuring or takeover.¹²⁹ Nor do they always achieve their goals, with success rates ranging from 18% in Asia to 61% in the US. Changes in board and payout policy stand the highest chance of achieving an outcome, though as noted, these are generally the least profitable types of outcomes.

Other unanswered questions abound. One common finding is that activist hedge funds tend to target firms that have been performing poorly prior to an intervention – investors like Bill Ackman embody value-oriented philosophy. From this, some claim that improvements may be due to the natural tendency for underperformance to be followed by an upturn in performance, rather than intervention *per se*. Indeed one study that compares the long-term financial value of targeted firms against a matched sample of non-targeted firms whose prior performance was similarly weak finds that post-intervention performance deteriorates *relative* to this control group.¹³⁰ Additional research is necessary to examine this insight, not least as there may exist subtle and latent differences between targeted and nontargeted firms – hence why, perhaps, they are targeted by an activist hedge fund in the first place.

Whatever the purported merits of hedge fund activism at an individual level, industry-wide

¹²⁶ Brav, A., Jiang, W., Partnoy, F., and Thomas, R. (2008) 'Hedge Fund Activism, Corporate Governance, and Firm Performance', *Journal of Finance* 63, 1729–1775.

¹²⁷ Brav, A., Jiang, W. and Kim, H. (2015) 'The Real Effects of Hedge Fund Activism: Productivity, Asset Allocation, and Labor Outcomes', *Review of Financial Studies* 28, 2723–2769.

¹²⁸ For more ambiguous consequences for other stakeholders such as creditors, see Klein, A. and Zur, E. (2011) 'The Impact of Hedge Fund Activism on the Target Firm's Existing Bondholders', *Review of Financial Studies* 24, 1735–1771 and Feng, F., Xu, Q. and Zhu, H. (2016) 'Caught in the Cross-Fire: Creditor Reaction to the Threat of Hedge Fund Activism'.

¹²⁹ Becht, M., Franks, J., Grant, J. and Wagner, H. (2015) 'The Returns to Hedge Fund Activism: An International Study'; European Corporate Governance Institute Working Paper No. 402/2014.

¹³⁰ Cremers, M., Giambona, E., Sepe, S. and Wang, Y. (2015) 'Hedge Fund Activism and Long-Term Firm Value'. Other studies have used matching methods to explore counterfactuals and find that hedge fund activism is beneficial to shareholder interests, though not on the subject of the long-term financial value of firms.

effects need to be taken into account. For instance, the introduction of cutting-edge technology or good management practice at a target firm may lead to their diffusion through the rest of the industry. On the other hand, improvements may increase the pressure on rivals to cut costs and prices in a bid to shore up market share with detrimental effects for investment in innovation and intangibles. Partly supporting the latter hypothesis, a recent study finds that three years after a hedge intervention, rival firms on average have 3.2% lower price-cost margins yet over 2% lower productivity compared to firms whose competitors were not targets of hedge fund activists.¹³¹ Policymakers should not necessarily lament these dynamics where they accelerate weaker peers to exit the industry: exit by less productive firms is the rough-and-tumble of a dynamic economy; however where they result in greater industry consolidation, the consequences for competition and the economy as a whole may be less benign.

Barriers to blockholding

Blockholding flourishes in a supportive legal, cultural and regulatory ecosystem.¹³² There are a number of encouraging factors. Allowing mutual funds, for example, to acquire the large positions needed to exercise control by relaxing requirements to have diversified portfolios will foster blockholding – as would introducing ‘safe harbour’ provisions (see Chapter 5) to allow institutional investors whose holdings exceed given thresholds to have access to privileged information without legal penalty. Permitting founders’ preferences when going public to be expressed (as argued in Chapter 2) is another encouraging factor. The financing structures through which firms grow, and how shares are issued and placed also matters – and it is obvious that the more right-sized companies that make it more or less easy to acquire a significant percentage stake plays a critical role.¹³³ It is also important that the disclosure regime allows prospective blockholders to purchase shares at prices that do not yet fully reflect the expected value of their future monitoring and engagement activities: too much disclosure too soon and the price may be moved against the blockholder.¹³⁴

There is an active debate whether liquidity helps or hinders blockholding. Conventional wisdom is that less liquid stock markets are desirable – by locking in shareholders for the long term, they force them to engage with the firm.¹³⁵ Using the tax rate on realised capital

¹³¹ Aslan, H. and Kumar, P. (2016) ‘The Product Market Effects of Hedge Fund Activism’, *Journal of Financial Economics* 119, 226–248.

¹³² Mark Roe goes so far as to argue that democratic norms and political economy have constrained the development of blockholding. See Roe, M. (1996) ‘Strong Managers, Weak Owners: The Political Roots of American Corporate Finance’; Princeton University Press.

¹³³ Pagano, M. and Röell, A. (1998) ‘The Choice of Stock Ownership Structure: Agency Costs, Monitoring, and the Decision to Go Public’, *Quarterly Journal of Economics* 113, 187–225.

¹³⁴ Bebchuk, L. and Jackson, R. ‘The Law and Economics of Blockholder Disclosure’, *Harvard Business Law Review* 2, 40–60.

¹³⁵ Bhidé, A. (1993) ‘The Hidden Costs of Stock Market Liquidity’, *Journal of Financial Economics* 34, 31–51. See also Roosenboom, P., Schlingemann, F. and Vasconcelos, M. (2014) ‘Does Stock Liquidity Affect the Incentives to Monitor: Evidence from Corporate Takeovers’, *Review of Financial Studies* 27, 2392–2433. In the context of M&As’ liquidity the authors find that liquidity is associated with lower M&A returns due to weaker monitoring of management decisions. This effect, however, holds only when there is a single blockholder (and thus governance through voice is most likely).

gains as a measure of lock-in, one study finds that funds with a higher level of gains on a stock are more likely to stay the course and oppose a firm's management.¹³⁶ These investors are more likely to win a vote against management *and* less likely to propose a contentious vote, suggesting that they help nip agency conflicts in the bud before they arise, presumably through behind the scenes engagements.¹³⁷ These lock-in governance effects are found to have tangible benefits for both the firms held by the funds and the funds themselves in the form of higher net flows.

But liquidity matters for several critical reasons: it is easier to acquire a stake in a more liquid market. In addition, a blockholder is more willing to acquire a large stake if she knows that she is able to exit later. Simply advocating illiquidity because it will encourage voice confronts a chicken and egg problem – the anticipation of being locked in may deter the block from forming in the first place. Indeed, a study shows that liquidity encourages block formation.¹³⁸ To identify causal effects, the authors use the decimalisation of the U.S. stock exchanges in 2001 as an exogenous shock to liquidity.

Restricting short-term trading, on the other hand, can worsen governance. Even if a blockholder learns that a firm is sacrificing long-run value, she will be unable to trade on this information and discipline managers. And because a blockholder knows that she cannot sell and profit on this long-term information, she will not bother to collect it to begin with. Indeed, the above study uses decimalisation to show that liquidity enhances governance through exit and ultimately operating performance. In addition, liquidity may have substantive effects for voice.¹³⁹

Looser informal arrangements between investors can provide an alternative to blockholders and a focal point for engagement. A good example is the Canadian Coalition for Good Governance, which manages approximately \$3 trillion in assets on behalf of institutional investors. Among its achievements, it has secured firms' adoption of shareholder democracy measures, say-on-pay advisory votes and improved compensation structure and disclosure, with benefits spilling over to non-engaged firms through board interlocks and codes of good practice.¹⁴⁰ Following the Kay Report, there are moves in the UK to strengthen coordination between institutional investors. However, coordination in a British context comes with costs and can be difficult to organise, with non-UK shareholders and British shareholders having

¹³⁶ Dimmock, S., Gerken, W., Ivkovich, Z. and Weisbenner, S. (2016) 'Capital Gains Lock-In and Governance Choices'; NBER Working Paper. The authors exploit the fact that capital gains liability and thus the governance lock-in effects varies across different investors in the same stock.

¹³⁷ Per Michelle Edkins, Global Head of Corporate Governance and Responsible Investment at BlackRock: "In our experience [private engagement] has a fair degree of traction with management. And we can raise [an] issue without having to dictate how management should address it. In a way, that's always the weakness of the shareholder proposal route."

¹³⁸ Edmans, A., Fang, V. and Zur, E. (2013) 'The Effect of Liquidity on Governance', *Review of Financial Studies* 26, 1443–1482.

¹³⁹ Norli, O., Ostergaard, C. and Schindele, I. (2015) 'Liquidity and Shareholder Activism', *Review of Financial Studies* 28, 486–520.

¹⁴⁰ Doidge, C., Dyck, A., Mahmudi, H. and Virani, A. (2015) 'Can Institutional Investors Improve Corporate Governance through Collective Action?'; Rotman School of Management Working Paper No. 2635662.

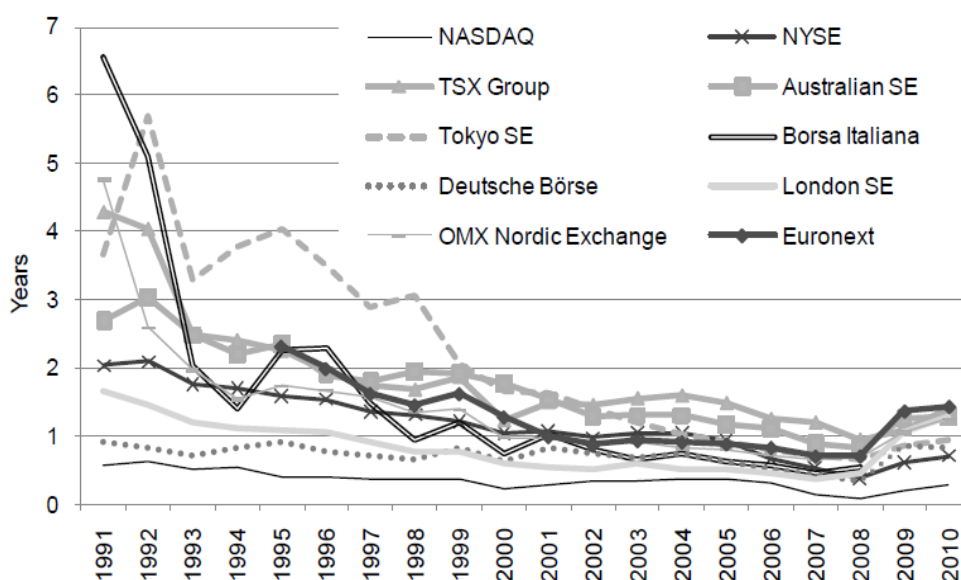
cultural and business model differences, as we discuss below.¹⁴¹

British ownership structures compared

This is particularly important in the context of the steady decline in the *average* holding period of shares on stock exchanges around the world. As Figure 3.3 shows, the phenomenon is a global one, not confined to the UK, but what makes it particularly relevant to the UK is the combination of the declining holding period of shares with the absence of blockholders. In other countries, the holding period of dispersed shares is of limited significance because control does not reside in the hands of the dispersed shareholders but with the blockholders who trade their shares infrequently. As remarked above, in the UK there are few anchor shareholders to lend stability to a rapid turnover of dispersed shareholdings.

¹⁴¹ See Bebchuk, L. (2007) 'The Myth of the Shareholder Franchise', *Virginia Law Review* 93, 675–732.

Figure 3.3: Average holding period of shares between 1991 and 2010

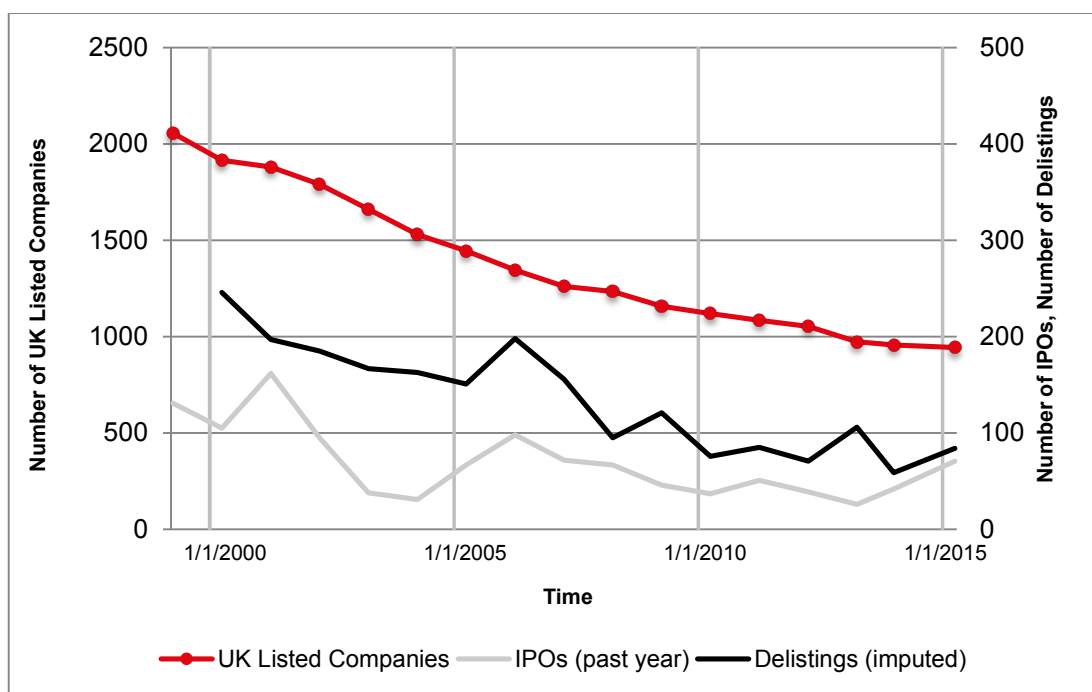


Source: Della Croce, Stewart and Yermo OECD (2011)

As demonstrated in Chapter 2 the UK is an outlier in the emphasis it places on investor protection and the absence of dominant blockholders. But it is also an outlier in the dominance of foreign share ownership and the fragmented nature of its shareholder base. The justification is that this approach promotes a flourishing stock market: in fact it has actually been associated with a shrivelling stock market in comparison with other countries that have historically had weaker investor protection and large blockholders. Some of the same features are mirrored in the US, but to a lesser extent on account of the less restrictive nature of the American regulatory system. The unique UK regulatory approach has neither benefited the UK stock market, nor the British corporate sector by inhibiting block shareholdings with the knock on impact on wider economic performance. It has been self-defeating at every level.

The UK is upheld as a model of a stock market oriented economy with strong investor protection. But over the last few decades the UK has witnessed a remarkable decline in the numbers of companies quoted on its stock market. Figure 3.4 records that the number of UK listed companies on the main market of the LSE has halved from around 2,000 in 2000 to 1,000 in 2015. As Figure 3.4 shows, this is associated with a higher level of delistings of companies coming off the stock market over the period than new listings of companies coming on to the stock market in the form of IPOs. It is the culmination of a long-term trend that has seen the number of listed companies in the UK halve from around 4,000 in the 1960s to 2,000 at the end of the century.

Figure 3.4: Number of new listing and delistings between 1999 and 2012 for the UK



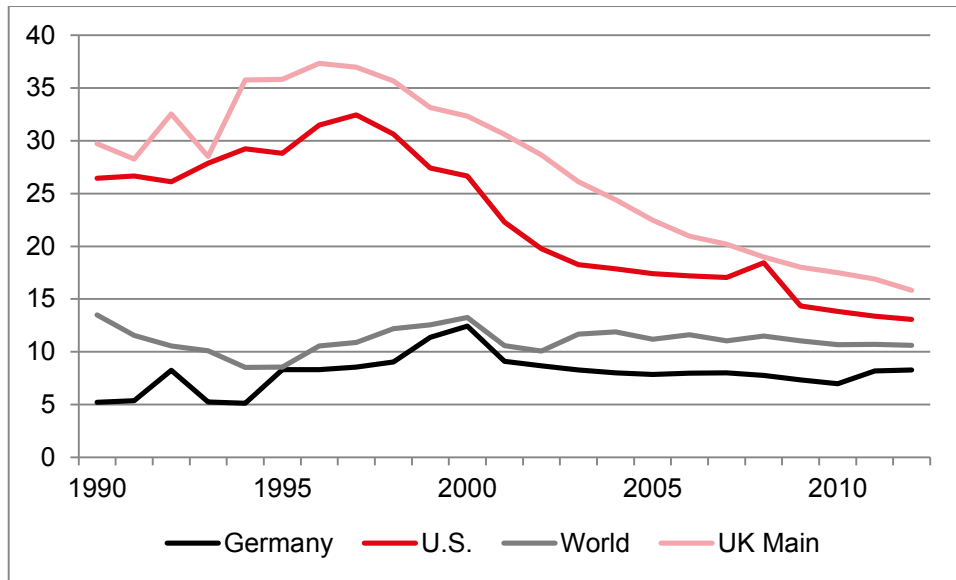
Julian Franks and Colin Mayer (2016) (based on data from the London Stock Exchange)

The UK is not the only country to have witnessed a marked decline in the size of its stock market; so too has the US, if far less dramatically. The Economist reported in May 2012 that the number of public corporations in America dropped by 38% from 1987. Michael Jensen, the well-known Harvard Business School finance professor, predicted the “eclipse of the public corporation” in the 1980s¹⁴²; Jensen’s prediction now appears to be being realised, at least in the US.

But it has not been realised everywhere. As their names suggest, emerging markets have until recently experienced rapidly expanding stock markets. But so too have some developed markets such as Japan where the number of listed companies on the First Section of the Tokyo Stock Exchange has increased from 1,400 to 1,800 over the same period from 2000 to 2014 that the LSE main market halved. Figure 3.5 shows the strong convergence that has taken place in the number of listed companies in the UK, US, Germany and globally measured in relation to the size of countries’ populations.

¹⁴² Jensen, M. (1989) ‘Eclipse of the Public Corporation’, *Harvard Business Review* September/October.

Figure 3.5: Number of listed firms between 1990 and 2012 for Germany, UK, US and the World

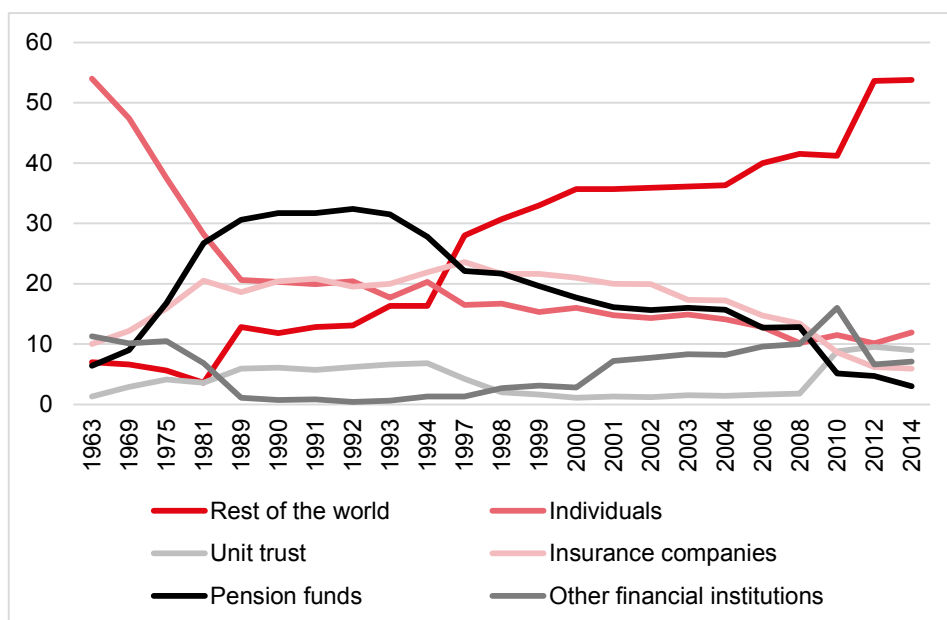


Source: Julian Franks, Colin Mayer and Hannes Wagner (2016)

The figure shows the number of domestically incorporated companies listed on a country's stock exchanges over population in millions. Data for the UK are for the main stock market. Data are from the World Bank and London Stock Exchange.

But it is not just the size of stock markets that has changed; so too has the composition of the ownership of the companies that remain listed on them. Figure 3.6 shows ownership of UK listed companies over the period 1963 to 2010. It records the historical dominance of individual shareholdings that prevailed until the end of the 1960s and its replacement by institutional holdings first in the form of pension funds and insurance companies and then from the 1980s by foreign investors. Most recently, from the beginning of this century, holdings by other financial institutions, such as hedge funds and private equity firms, have increased proportionally, reflecting the deep changes in the UK savings and pensions markets.

Figure 3.6: Registered ownership of UK quoted shares



Source: ONS

Foreign ownership has increased significantly in most markets around the world as the benefits of international diversification of portfolios have been recognized. However, outside the UK, the internationalisation of portfolios has occurred against the backdrop of a continuing presence of dominant blockholders. For example in Germany the proportion of companies with dominant family owners controlling more than 25% of shares of the largest 200 non-financial companies has remained in excess of 30% over the last 5 years.¹⁴³ As noted above, even in the US, the impact of internationalisation of shareholdings has been moderated by a continuing presence of dominant domestic blockholders.

Increased foreign ownership of UK equities is not bad in itself: openness can be vital to learning from other groups of shareholders and the transmission of good corporate governance standards.¹⁴⁴ However, it can also create inefficiencies through higher coordination costs due to lack of trust and cohesion.¹⁴⁵ John Kay observed in his review that shareholders are now less likely to know each other well, which may have narrowed

¹⁴³ Franks, J., Mayer, C. and Wagner, H. (2016) 'The Survival of the Weakest: Flourishing Family Firms in Germany', *Journal of Applied Corporate Finance* 27, 27–35.

¹⁴⁴ Aggarwal, R., Erel, I., Ferreira, M. and Matos, P. (2011) 'Does Governance Travel around the World? Evidence from Institutional Investors', *Journal of Financial Economics* 100, 154–181 and Foucault, T. and Fresard, L. (2012) 'Cross-Listing, Investment Sensitivity to Stock Price, and the Learning Hypothesis', *Review of Financial Studies* 25, 3305–3350.

¹⁴⁵ This trade-off is present in many areas of economic and social life: see Ashraf, Q. & Galor, O. (2013) 'Genetic Diversity and the Origins of Cultural Fragmentation', *American Economic Review* 103, 528–533.

opportunities for collective action where blocks are missing or too small.¹⁴⁶ Moreover, foreign – particularly US – firms have tended to be more guarded in their approach, shaped by domestic legal traditions that impose greater restrictions on activities such as concert party and insider trading.¹⁴⁷ The influence of local culture and institutions may also be a reason why activists struggle to add value when they target firms outside their respective home countries or do not specialise geographically.¹⁴⁸

The UK asset management industry

The Kay Review described the explosion of intermediaries standing between the individual investor and her final investment to an extent that arguably it has become dysfunctional. Each investing institution has its investment managers: but in addition shares are held by custodian institutions who are independent from fund managers, whose performance in turn is assessed by a thriving industry of independent actuaries and specialist advisers.

Part of this reflects the professionalisation of the industry, with the proper desire to embed checks and balances to guard against fraud and malfeasance while ensuring best practice. But the consequence is that intermediaries are at arms-length from the underlying assets: they reinforce the trend away from shareholder as owner to shareholder as disengaged investor – and each acts as a potential veto point in any effort to assemble blocks, co-ordinate activity or mobilise all the parties around any ambitious goal.¹⁴⁹

Moreover there is intense competition for investment mandates based on the relative performance of funds under management compared against relevant benchmarks. Again, this militates against understanding the underlying value of the businesses in which investments are made, and leads to herding as managers look to avoid lengthy periods of underperformance. What matters is what other managers are doing: if you follow them then you will not be caught out by being a poor performer relative to the benchmark. This has led to another phenomenon: because it is difficult to consistently beat the benchmarks, investors have turned to funds, which simply invest in the assets constituting the benchmark passively. This ‘passive investment’ permits extremely low fees, so reducing costs and so achieving benchmark returns cost effectively. The concern that the focus on costs would hollow out good stewardship, which is time-consuming and resource-intensive work has not completely materialised, though the jury is out whether engagement by passive investors has translated

¹⁴⁶ Huang, K. and Kang, J. (2016) ‘Geographic Concentration of Institutions, Corporate Governance, and Firm Value’. Available at SSRN: <http://ssrn.com/abstract=2644968>. The authors use the introduction of new direct airline routes as an exogenous shock to geographic concentration.

¹⁴⁷ McCahery, Sautner and Starks op cit. find that rules on acting in concert among the main impediments to shareholder engagement. Presumably these difficulties are amplified where shareholders, coming from different jurisdictions, have different understandings of the law and permissible practice.

¹⁴⁸ Becht, M., Franks, J., Grant, J. and Wagner, H. op. cit.

¹⁴⁹ World Economic Forum (2011) ‘The Future of Long-Term Investing’.

into improved firm value and performance.¹⁵⁰ The increased presence of passive investors may also encourage engagement by other shareholders.¹⁵¹ The counter argument is that as passive investing grows it reinforces whatever price momentum there is in the market, exposing investors to extreme and irrational price swings.¹⁵² Anxieties that passive management is hindering price discovery are not without reason, though there may be structural limits to this phenomenon.¹⁵³

Even welcome attempts to move away from relative performance to focus on absolute returns tend to encourage disengagement and weak stewardship – in part because many absolute returns funds – Standard Life Investment’s GARS and being an obvious example – target consistently positive returns through complex derivative techniques such as index futures, tactical overlays and significant levels of diversification rather than necessarily by focusing on the underlying company and its strategy.

These trends are reinforced by the remarkable decline in the proportion of equities held by traditional long-term investing institutions – pension funds and insurance companies.¹⁵⁴ Figure 3.7 shows the changing composition of UK corporate and local authority pension fund assets. It shows a decline in the equity component of both, but in particular of UK corporate pension fund assets. These have fallen from nearly 80% during the 1980s to under 40% by the 2010s.

¹⁵⁰ Appel, I., Gormley, T. and Keim, D. (2016) ‘Passive Investors, Not Passive Owners’, *Journal of Financial Economics*; Forthcoming.

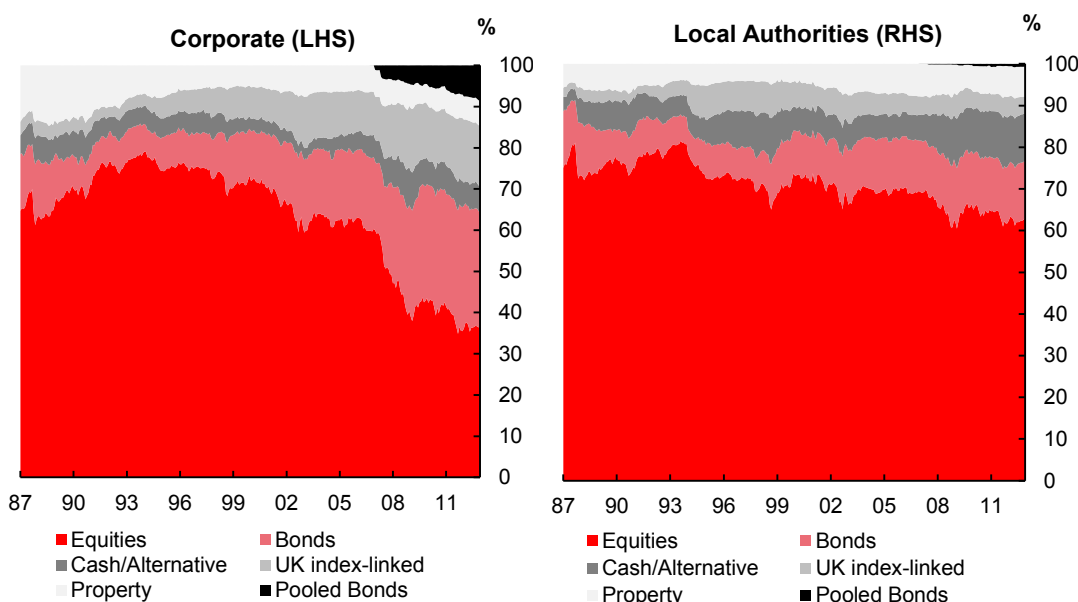
¹⁵¹ Appel, I., Gormley, T. and Keim, D. (2016) ‘Standing on the Shoulders of Giants: The Effect of Passive Investors on Activism’, *Journal of Financial Economics*; Working Paper.

¹⁵² In 2000, on the eve of the tech bubble, an investor in a Russell 1000 Growth Index would have owned more than 50% in Information Technology (IT) stocks.

¹⁵³ Qin, N. and Singal, V. (2015) ‘Indexing and Stock Price Efficiency’, *Financial Management* 44, 875–904. That swings in allocations between active and passive may be ultimately self-correcting is suggested by Pastor, L. and Stambaugh, R. (2012) ‘On the Size of the Active Management Industry’, *Journal of Political Economy* 120, 740–781.

¹⁵⁴ Morgan Stanley Blue Paper (2013) ‘Great Rotation? Probably Not’.

Figure 3.7: UK defined benefit scheme asset allocation (nominal)



Source: State Street Global Services Performance Services and Bank of England calculations

Part of the explanation is that as the population ages and pension funds approach maturity, so there is a natural portfolio move from risky equity investment to cash, bonds and alternatives such as infrastructure so that funds can lock in guaranteed values to assure the predicted annuity income. But another important influence on the pattern of holdings has been regulation. By valuing pension fund liabilities in relation to the yield on government index linked securities, the minimum funding requirement and its successor, the statutory funding objective, encouraged pension funds, in order avoid volatility on the corporate balance sheet, to match their assets with their liabilities by holding index linked gilts instead of equities. Solvency has similarly discouraged insurers from holding equity. The systemic effect of this has been to expedite the decline of DB schemes in the UK and to exacerbate the bubble in long-dated bonds and, in particular, index linked gilts – in the UK supply simply cannot meet demand.¹⁵⁵ Similarly, this has had a knock on impact to the sponsoring companies themselves. The increased cost of pension provision over the life of a scheme resulting from the shift to risk-free assets has exacerbated deficits which in turn has diverted earnings away from long-term value creating investments.¹⁵⁶ This short-term focus is not necessarily in the interests of either party and has been recognised by the creation of a new objective for the Pensions Regulator to “to minimise any adverse impact on the sustainable growth of an employer.”

¹⁵⁵ Fathom Consulting (2012) ‘Who Carries the Risk? Asset-allocation Challenges for Defined-benefit Pension Schemes and their Sponsors on the Road to Buyout’.

¹⁵⁶ There is also the phenomenon of pension funds with the weakest balance sheets (net funding position) attempting to close deficits by re-risking. In effect they are engaged in a gamble for

While the traditional DB Pension has been in steady decline in the UK for a couple of decades, the introduction of automatic enrolment led to active DC memberships exceeding DB memberships for the first time in 2015 – now in excess of 3 million. While the proportion of equity holdings in DB funds has been steadily declining for the reasons explained above, in DC schemes, the average equity component of a FTSE DC scheme is in excess of 70%.¹⁵⁷ Similarly, while there are many thousands of small DB funds in the UK, including a very large tail of very small schemes, the DC market is much more concentrated. The recent OFT study noted that the provision of contract and bundled trust based schemes is relatively concentrated, with four large providers holding the majority of schemes, assets and memberships – the largest four providers accounted for approximately 68% of the total AUM in the OFT's sample, 76% of schemes and 61% of memberships. In addition, the new breed of Master Trusts, such as NEST, NOW: and the People's Pension each have many hundreds of thousands of members. The OFT also unequivocally concluded that competition is not working in this market and found that fees and charges are often high, impossible to

redemption, though this behaviour is likely to be unsustainable and leave investors worse-off. See IMF <http://www.imf.org/External/Pubs/FT/GFSR/2013/01/pdf/c1.pdf>

¹⁵⁷ See Schroders annual survey SOURCE.

compare and frequently cancel out investment returns.¹⁵⁸

All these trends coalesce. Despite a greater willingness to express their opinions at shareholder meetings, there are question marks over whether there has been a meaningful shift in stewardship practices. For one thing many managers have relatively small corporate governance departments for them to be able to exercise active governance over the large number of holdings in their portfolios. Indeed where resources are made available, there is feeling in the industry that executive remuneration issues are over-privileged at the expense of more fundamental factors such as corporate performance, culture and board leadership.¹⁵⁹ In addition, the shift to DC is being accompanied by a focus on fees and a dilution of traditional trustee governance structures, as a result there is an increased use of passive management and a potentially greater disconnect between savers and their investments. This new environment thus presents both an opportunity to increase engaged ownership of UK companies but also poses a risk that ownership practices may be reduced further.

The UK Stewardship Code which now has almost 300 signatories, including roughly 200 asset managers who collectively manage a significant portion of UK listed equities, was formally adopted by the FRC in 2010 following a recommendation by Sir David Walker – the Code had existed informally for a number of years previously under the auspices of the Institutional Shareholders Committee (ISC). The Investment Management Association's (IMA) annual stewardship survey finds that headcount dedicated to engagement activities has increased by approximately 30% since the Kay Review, albeit from a low base and resourced via portfolio managers and analysts rather than dedicated specialists.¹⁶⁰ Despite this progress, improvements in engagement have not been consistent across companies, especially in the mid-cap sector. The FRC has recently acknowledged that while lauded internationally the formal adoption of the UK Stewardship Code has resulted in only a modest improvement in quality engagement and among those already converted to this agenda.

There are concerns that signatories of the Stewardship Code are not keeping their statements against the Code up to date and not sufficiently disclosing conflicts of interest or providing adequate explanations.¹⁶¹ In the words of one corporate governance head: "Of the roughly 300 members of the Stewardship Code, I would say there are only about 30 institutions that are doing the job properly."¹⁶² In a recent survey of companies undertaken by

¹⁵⁸ OFT (2014) 'Defined Contribution Workplace Pension Market Study'.

¹⁵⁹ Investment Association (2016) 'Supporting UK Productivity with Long-Term Investment: the Investment Association's Productivity Action Plan'.

¹⁶⁰ IMA (2015) 'Adherence to the FRC's Stewardship Code: At 30 September 2014'. Dedicated specialists accounted for only 11% of the headcount responsible for stewardship. Clearly, there may be sensible reasons for this skew: one risk of having dedicated specialists handle stewardship is that they are not sufficiently integrated into the investment process and thus do not accurately represent the views of PMs.

¹⁶¹ BIS (2014) 'Implementation of the Kay Review: Progress Report'.

¹⁶² Wong, S. (2015) 'Is Institutional Investor Stewardship Still Elusive', *Butterworths Journal of International Banking and Financial Law* July/August, 508–512.

ICSA on the impact of the stewardship code, 58% of FTSE companies reported that they had seen more investor engagement, while 40% say that it is unchanged; nearly half of respondents felt that engagement had got a 'little better'.¹⁶³ The anecdotal feedback however, that 'there is more activity from a minority of investors' rings true. In any case many fund managers do not regard themselves as having the expertise to engage actively in corporate management: their skills are in traditional stock selection, not launching proxy fights or providing strategic advice. Suggestions for improvement are made in Chapter 5.

The role of asset owners

For asset owners such as pension funds and insurance companies looking to outsource asset management functions, a particular dilemma is lack of relevant expertise and knowledge at board and management levels, an issue recognised by the earlier Myners review. It is for this reason that The Pensions Act in the UK requires trustees to obtain and consider proper advice. The need for trustees to turn to external advisory – notably consultants and investment managers – lengthens the investment chain and multiplies agency conflicts.

While schemes in the UK report high levels of satisfaction with their investment consultants it is striking that these important agents do not receive much oversight despite their advice being so heavily relied upon.¹⁶⁴

It is also telling that in multiple surveys pension schemes report that the topic of stewardship is very rarely proactively raised with them by their investment consultants – despite these consulting firms themselves being signatories to the UK Stewardship Code. Over recent years, there has been a trend observed in the UK towards fiduciary management, with full fiduciary management particularly common amongst smaller schemes. Similarly at the upper end, there has been a shift towards increasing the size of internal investment expertise amongst larger schemes, although the role of internal investment teams empowers schemes there remains a grey area between the requirement to take advice contained in the Pensions Act and FSMA with respect to externally managed assets.

Many factors contribute the knowledge deficit among pension funds and other asset owners – from the background and training of trustees through to the small-scale nature of their operations. The UN Environment Programme Finance Initiative's *Inquiry into the design of a sustainable financial system* analysed second pillar pension funds in the United Kingdom and found that many of the UK's estimated 50,800 pension funds do not have the scale to deliver on beneficiary interests, including, but not limited to sustainability matters. This is particularly important with respect to the performance evaluation of asset managers: unable

¹⁶³ <https://www.icsa.org.uk/knowledge/governance-and-compliance/features/august-2015-add-value-by-increasing-freedom>

¹⁶⁴ Jenkinson, T., Jones, H. and Martinez, J. (2016) 'Picking Winners? Investment Consultants' Recommendations of Fund Managers', *Journal of Finance*; Forthcoming. They find that consultant recommendations have a very significant influence on fund flows, although the evidence that these recommendations add value is lacking.

to differentiate true performance through a holistic assessment of investment process and philosophy and reluctant to give external agents too much discretion, they fall back on crude, though tightly defined metrics such as quarterly returns against a pre-selected market benchmark when evaluating managers – reinforcing a short-term orientation.¹⁶⁵ In Chapter 5 we discuss option to consolidate small pension funds into larger funds.

On one level, asset managers are thus reflecting what their clients want as they are legally obliged to. Pension funds want steady, safe and unspectacular returns while many individual savers are keen buyers of equity income funds in the hope of better returns in a world of low interest rates.¹⁶⁶ To quote the proverb, he who pays the piper calls the tune.¹⁶⁷ Evidence for this can be seen in the fact that fund flows are highly sensitive to performance – and this, in turn, has a strong bearing on the extent to which managers churn their portfolios.¹⁶⁸ This emphasis can have far-reaching consequences along the investment chain, right down to impairing the effectiveness of blockholding.¹⁶⁹

However it would be wrong to be too despairing. Some pension funds are concerned to promote purpose (Hermes) along with some asset management groups (Fidelity) – both members of this Taskforce. Nor is this behaviour confined to Britain. In Sweden, there is evidence of institutional investors building up larger stakes in companies, which they intend to hold on a long-term (for example 10 year) basis. In addition they regard their role as supporting management in the fulfilment of corporate purpose over the long term and providing engaged participation not of a short-term hostile nature but of a long-term supportive form.¹⁷⁰ There can be change, but it does need to be succoured.

Companies can help themselves

As argued in Chapter 1, companies themselves can help change investor focus. Jeff Bezos, CEO of Amazon, puts it in the following terms: “With respect to investors, there is a great Warren Buffett-ism. You can hold a rock concert and that can be successful, and you can hold ballet and that can be successful, but don’t hold a rock concert and advertise it as a ballet. If you’re very clear to the outside world that you’re taking a long-term approach, then people can self-select in.”¹⁷¹ Research supports his point so that transcripts of earnings conference calls for keywords related to the disclosure of short- and long-term information finds that companies with a short-term orientation attract investors who are fixated on

¹⁶⁵ Vayanos, D. and Woolley, P. (2016) ‘Curse of the Benchmarks’; LSE Financial Markets Group Discussion Paper No.747.

¹⁶⁶ Empirical Research (2013) ‘The Future of the Money Management Industry: Things Have Changed’.

¹⁶⁷ Thanks to Quintin Price for this analogy and his thoughts on the subject. Private correspondence.

¹⁶⁸ Chevalier, J. and Ellison, G. (1997) ‘Risk Taking by Mutual Funds as a Response to Incentives’, *Journal of Political Economy* 105, 1167–1200; Lynch, A. and Musto, D. (2003) ‘How Investors Interpret Past Returns’, 58, 2033–2058; and Cella, C., Ellul, A. and Giannetti, M. (2013) ‘Investors’ Horizons and the Amplification of Market Shocks’, *Review of Financial Studies* 26, 1607–1648.

¹⁶⁹ Dasgupta, A. and Piacentino, G. op. cit.

¹⁷⁰ Nachemson-Ekwall, S. (2015), mimeo.

¹⁷¹ Quoted in Mackey, J. and Sisodia, R. (2013) ‘Conscious Capitalism: Liberating the Heroic Spirit of Business’; Harvard Business Review Press.

quarterly numbers. Rather than making decisions against their will, executives are often willing accomplices in this dance.¹⁷²

Some are prepared to stay on the sidelines, sometimes at personal cost. Porsche was expelled from the M-DAX index in August 2001, for refusing to comply with its requirement for quarterly reporting, arguing that it led to myopia.

But much more can be done on this front. The Focussing Capital on the Long Term project, to this end, identified 10 ways companies can communicate a long-term strategy to investors and help get them onside. They include making a clear statement of purpose (citing Electrolux), explaining how value is generated (South Africa's NedBank), setting out in detail the company's main market drivers, market share and order book (Metso) and so on – even extending to Britain's Berkeley Homes setting out long-term plans that involve executives only being rewarded on their achievement in 2021. Unilever's experience was cited in Chapter 1. It is true that such approaches are harder in a British context with the particularities cited above – but they can be attempted nonetheless. Again some options for change are discussed in Chapter 5.

Executive incentives

Remuneration practices, as indicated in Chapter 1, are at the heart of aligning management action with purpose and performance. If incentives do not match with purpose, it will not be delivered. Thus, it is critical to ensure that executive reward is aligned with the creation of long-term value.

Early efforts at aligning executive pay with shareholders focused on the use of options or shares with time-based vesting. Time based vesting means that the options or shares are awarded on a certain date but only released to the executive (so-called 'vesting') if they are still employed on a certain date. In the US awards often vested in equal portions on the first, second, and third anniversaries of grant, whereas in Europe, and in particular the UK, vesting of the entire award after three years was more common.

In the 1990s corporate governance and shareholder guidelines pressed for performance conditions to be added to share and option awards: so-called performance-based vesting. Shares or options awarded to an executive would only be released to them if corporate performance conditions were met over, typically, a three year period. Pressure from bodies such as the Association of British Insurers and the National Association of Pension Funds meant that performance-based vesting was rapidly adopted in the UK towards the end of the last century. The practice has subsequently spread throughout the developed world.

The executive pay model that has now evolved in developed markets typically provides shares (rather than options) with performance-based vesting and release of the shares over

¹⁷² Brochet, F., Loumiotis, M. and Serafeim, G. (2015) 'Speaking of the Short-Term: Disclosure Horizon and Managerial Myopia', *Review of Accounting Studies*; Forthcoming.

3 to 5 years. Debt is rarely considered as a pay vehicle; bonuses are often comparable in size to equity grants and are frequently based on short-term measures of financial performance such as profit and revenues. Narrative disclosures are often boilerplate in nature rather than revealing genuine insight or creating board accountability. All tend to reinforce the trend for directors to behave in response to shareholders-as-short term investors rather than engaged owners. In short they lean against the delivery of purpose.

1. Paying in long-dated equity

There is strong evidence that payment in equity improves financial performance. A comprehensive study found that companies with high equity incentives outperform those with low equity incentives by 4-10% per year.¹⁷³ This outperformance is even stronger in firms with weak governance and weak product market competition, suggesting that equity incentives cause managers to take decisions that add shareholder value rather than reverse causality (managers who expect future good performance are more willing to hold stock today).

But the current prevailing model of executive incentives has significant weaknesses. Corporate governance 'best practice' and investor guidelines have led to performance-based vesting conditions being added to bonus and stock awards. Although these seem to support a robust pay-for-performance philosophy, they have unintended consequences. Performance is typically tested over three years, which may not be long enough fully to align executives with long-term value creation. Performance measures such as relative total shareholder return, earnings per share or return on capital can in the short term be very noisy and achieved in ways that are inconsistent with long-term value creation, and short-term performance scales can reward volatility of performance rather than sustained improvement.

Any set of incentive metrics measured over a few years will be an incomplete view of business performance and can encourage executives to maximise pay at the expense of purposeful or long term contribution. With the quantum of executive pay now enabling life changing sums to be earned in just a few years, any set of measures over short-term period (one to three years) gives rise to significant risks of gaming or moral hazard.

One approach is to extend performance periods beyond three years. But if targets are difficult to calibrate over three years it can be impossible over five. Executives heavily discount awards that are subject to performance conditionality over more than a few years.¹⁷⁴

Relative total shareholder return measured over three to five years can encourage

¹⁷³ Von Liliendorf-Toal, U. and Ruenzi, S. (2014) 'CEO Ownership, Stock Market Performance, and Managerial Discretion', *Journal of Finance* 69, 1013–1050.

¹⁷⁴ Pepper, A. (2015) 'The Economic Psychology of Incentives: New Design Principles for Executive Pay'; Palgrave-MacMillan.

companies to adopt the leverage of the most leveraged peer in order to out-perform: BHP Billiton underperformed the other miners during the commodity boom arguably because it had the strongest balance sheet; three of the top four relative TSR performers in the run up to the financial crisis in the banking sector were Bradford & Bingley, Northern Rock, and HBOS, whereas more stable banks such as HSBC, Barclays, Lloyds underperformed. Measures such as EPS create similar incentives to focus on short-term performance.

Early vesting of equity can lead to perverse incentives. A large-scale study finds that, in quarters in which CEO equity vests, R&D and capital expenditure both fall, and the firm is more likely to just meet or narrowly beat the analyst earnings target, consistent with vesting equity leading to the CEO being concerned with the short-term stock price.¹⁷⁵ Another paper shows that in months in which the CEO's equity vests, the firm releases more news items and more positive news items, and that it strategically reallocates news from adjacent months to facilitate this. These news releases lead to short-term increases in the stock price and trading volume, which the CEO takes advantage of by cashing out shortly afterwards.¹⁷⁶

At its worst, a culture of basing vesting on short-term performance measures can lead to excessive risk-taking, unethical behaviour and the psychological costs of goal failure, common side effects of so-called stretch goals.¹⁷⁷

The problems of using short-term financial measures (over one to three years) and the difficulty of agreeing more complex metrics, supports the view that making executives significant long-term shareholders through time-based long term vesting and holding periods works best. Conceptually the proposition is to persuade them to behave more as engaged owners. In many respects, the long-term stock price is an appropriate performance measure.¹⁷⁸ In the long-run, every executive decision will eventually show up in the stock price. But how long is long-run? Executives may face a long wait. Recall evidence from Chapter 1 that highly visible and readily intelligible information such as featuring on Fortune's *100 Best Companies to Work For In America* list can take four to five years to be reflected into the share price. It is not unreasonable to assume that the lag is even longer for information that is more opaque, technologically sophisticated and difficult to verify. A number of investors' and banking regulators' views on vesting periods coalesce around a period of up to 5 to 7 years (see for example the Investment Association,¹⁷⁹ Old Mutual Global Investors,¹⁸⁰ Fidelity,¹⁸¹ the Prudential Regulatory Authority,¹⁸² and the European

¹⁷⁵ Edmans, A., Fang, V. and Lewellen, K. (2016) 'Equity Vesting and Investment'. Working Paper.

¹⁷⁶ Edmans, A., Goncalves-Pinto, L., Groen-Xu, M. and Wang, Y. (2016) 'Strategic News Releases in Equity Vesting Months'. Working Paper.

¹⁷⁷ Ordóñez, L., Schweitzer, M., Galinsky, A. and Bazerman, M. (2009) 'Goals Gone Wild: The Systematic Side Effects of Over-Prescribing Goal Setting', *Academy of Management Perspectives* 23, 6–16.

¹⁷⁸ Edmans, A., Gabaix, X., Sadzik, T. and Sannikov, Y. (2012) 'Dynamic CEO Compensation', *Journal of Finance* 67, 1603–1647.

¹⁷⁹ The Investment Association Principles of Remuneration, 11 November 2015.

¹⁸⁰ Emerton, Paul (2015) 'Executive Pay in the UK', Old Mutual Global Investors position paper.

¹⁸¹ Fidelity International Proxy Voting Guidelines.

¹⁸² Prudential Regulatory Authority Handbook, SYSC19A.

Banking Authority¹⁸³). A one-size-fits-all approach should not be adopted, but it seems clear that in many cases minimum vesting and holding periods of 5 years or longer will be appropriate.

By contrast, the median tenure of CEOs at the world's 2500 largest companies, by comparison, is 4.2 years and 5.6 years, depending on whether they take office after a forced or planned succession.¹⁸⁴ Executives are understandably concerned to ensure that they are paid fairly during this relatively short period. So it is not surprising that two-thirds more executives prefer an internal measure they can control to an external relative measure.

However, timeframes of tenure should not be confused with timeframes of accountability. At the most senior levels, and certainly for CEOs, it is reasonable for vesting and holding periods to apply on a phased basis for a number of years after they leave the company. This creates appropriate incentives for CEOs to ensure that their actions are sustainable over the long term. An important aspect of that sustainability is succession planning. Requiring CEOs to hold stock for a period after they leave the company should provide a powerful incentive to focus on this critical, but too often underemphasised, component of their role.

An argument against long-vesting equity is the level of discount that may be applied by executives to awards that are receivable too far into the future. This danger has been highlighted by Pepper.¹⁸⁵ Such discounts may put upwards pressure on the level of pay, if long-holding requirements are adopted. However, this may be a price worth paying if incentives for long-term behaviour are improved.

Should shares be the only form of equity used? In some situations it may be argued that equity provides insufficient performance-leverage either to attract executives or to incentivise the right behaviour. In such cases options may have their place, as they have been shown to have a clear effect on risk-taking.¹⁸⁶ Other forms of equity such as options, indexed equity (where the value of equity is indexed by performance relative to the overall market) all have theoretical merits in certain situations¹⁸⁷, although they add complexity. They can validly be considered as part of a long-term equity package, but are not considered further here.

2. Payment in debt

One purpose of incentives is to prevent executives being too risk averse, and to ensure they are taking appropriate business risks in support of shareholder returns. However in some

¹⁸³ European Banking Authority Guidelines on Sound Remuneration Policies, 21 December 2015.

¹⁸⁴ See Strategy&/PWC (2015) '2014 Study of CEOs, Governance and Success: The Value of Getting Succession Right', <http://www.strategyand.pwc.com/media/file/2014-Study-of-CEOs-Governance-and-Success.pdf>. The lower (higher) figure refers to the median tenure of CEOs who come in after a forced (planned) succession.

¹⁸⁵ Pepper op. cit.

¹⁸⁶ Shue, K. and Townsend, R. (2014) 'Swinging for the Fences', *Chicago Booth Research Paper No. 13-03*.

¹⁸⁷ Edmans, A. and Gabaix, X. (2015), 'Executive Compensation: A Modern Primer', *Journal of Economic Literature*; Forthcoming.

circumstances they may induce executives to take excessive risk. This is particularly the case in highly leveraged companies or industries. The value of equity rises if a risky project pays off, but it is protected by limited liability, and in the case of the banking sector probable government bail out, if things go wrong – thus, equity gives them a one-way bet. Similarly, if a firm is teetering towards liquidation, rather than optimally accepting a mild bankruptcy, the executive may ‘gamble for resurrection’. If the gamble fails, the bankruptcy will be severe, costing debtholders (and society) billions. But since the executive is no worse off than in a mild bankruptcy (equity is worth zero in bankruptcy, regardless of its severity), they might as well gamble.

A potential solution involves incentivising managers through debt as well as equity.¹⁸⁸ By aligning the manager with debtholders as well as equity holders, this causes them to internalise the costs to debtholders of undertaking risky actions. Indeed, evidence suggests that debt-based pay works. In the U.S., many executives receive substantial defined benefit pensions and deferred compensation, which have equal priority with unsecured creditors in bankruptcy and so are effectively debt. Debt-like compensation is associated with looser covenants, lower bond yields¹⁸⁹, and higher bond prices¹⁹⁰ suggesting that debtholders are indeed reassured by the CEO’s lower incentives to pass risk onto them. It is also associated with lower bankruptcy risk,¹⁹¹ lower stock return volatility, lower financial leverage, and higher asset liquidity.¹⁹² But at the same time as the role of equity pay has increased in packages, there has been a decisive move away from defined benefit pensions for senior executives, in particular the unfunded top up pensions that played the role of long-term debt obligations. This has the consequence of significantly increasing the equity share of executive packages at the expense of debt. There is unlikely to be shareholder or public support for returning to the days of generous defined benefit pension plans for executives. But there is no reason why part of the package should not be delivered in debt – it need not be given in the form of pensions, but can be given in the form of deferred compensation or actual debt securities. But the part of the package allocated to long term retirement savings provides a natural opportunity, as the longer the timeframe for the unsecured debt holding, the stronger the incentive to ensure long-term sustainability of the business.

The applicability of payment in debt extends broadly across industries. But the high leverage of the financial services industry, and the public interest in avoiding bankruptcy in this sector, means that this sector is a natural starting point for considering payment in debt. Indeed, the idea of debt-based pay has started to catch on in Europe. The November 2011 Liikanen Commission recommended bonuses be partly based on ‘bail-inable’ debt. UBS and Credit

¹⁸⁸ Edmans, A. and Liu, Q. (2011) ‘Inside Debt’ *Review of Finance* 15, 75–102.

¹⁸⁹ Anantharaman, D., Fang, V. and Gong, G. (2014) ‘Inside Debt and the Design of Corporate Debt Contracts’, *Management Science* 60, 1260–1280.

¹⁹⁰ Wei, C., and Yermack, D. (2011) ‘Investor Reactions to CEOs’ Inside Debt Incentives’, *Review of Financial Studies* 24, 3813–3840.

¹⁹¹ Sundaram, R. and Yermack, D. (2007) ‘Pay Me Later: Inside Debt and its Role in Managerial Compensation’, *Journal of Finance* 62, 1551–1588.

¹⁹² Cassell, C., Huang, S., Sanchez, J. and Stuart, M. (2012) ‘Seeking Safety: The Relation between CEO Inside Debt Holdings and the Riskiness of Firm Investment and Financial Policies’, *Journal of Financial Economics* 103, 588–610.

Suisse have started to pay bonuses in the form of convertible (Co-Co) bonds. Other candidates for adoption include industries subject to high levels of volatility and cyclicity, for example commodity industries or real estate, where credit-worthiness can change rapidly through the cycle.

In some industries and businesses the concern about whether executives are taking enough risk may outweigh the concern that incentives for risk-taking are excessive. There will not be a one-size-fits all answer. But companies should carefully consider the mix of equity and debt instruments that creates the right long-term incentives in the context of their circumstances.

3. Bonuses linked to strategy and purpose

While a very simple system based on long-dated equity, and potentially debt, may do the job, in many circumstances performance-based incentives will still play a role, especially if they can be re-oriented to delivering purpose. Incentives certainly can influence the focus of executives and therefore as part of a Board strategy of supporting a change in focus away from short-term behaviours, some use of traditional bonuses could be beneficial. This may be particularly true in relation to the incentives that a CEO sets for their top team, where payment in equity can result in incentives that are too remote and insufficiently supportive of clear accountability.

Use of appropriate incentive metrics, including for the CEO's pay, can also assist clear communication internally and externally about the organisation's purpose in a way that simple lengthening of equity vesting periods may not. And from a very practical perspective, competitive pay packages will need to offer an element of cash pay, which must be linked to performance in order to meet with public and investor acceptance.

So if traditional incentives continue to play a role, what are some of the guidelines for their use?

Practitioners understand the value of organising performance management according to different perspectives. This means ensuring balance within incentive systems to avoid excessive focus on one dimension of performance. Notwithstanding this recognition, some 75% of US businesses have no balance sheet or capital efficiency metrics in their disclosed performance measurement and long-term incentive plan design. More than 85% of the S&P 1500 have no disclosed link of remuneration to metrics aligned to future value such as return on new product development and new markets, customer satisfaction and other nonfinancial and strategic goals. Nor do plans incorporate a realistic behavioural account of motivation.¹⁹³

However, performance-based or nonfinancial incentives may have potential problems¹⁹⁴:

¹⁹³ Pepper op. cit.

¹⁹⁴ Ittner, C. and Larcker, D. (2003) 'Coming Up Short with Nonfinancial Performance', *Harvard Business Review* 81, 88–95.

First, there is a risk of limiting the CEO's focus onto a subset of metrics, which could have unintended consequences if the CEO focuses on that set of metrics to the exclusion of others. CEO jobs are complex and generally can't be reduced into a finite scorecard of weighted measures. Second, we have an inevitable information asymmetry relating to target setting and measurement for non-financial measures, which may put a Remuneration Committee in a weak position vis a vis a CEO, especially where sophisticated exercises of judgement are necessary. This is evidenced by the UK data, which shows that around three quarters of companies award above target incentives each year, suggesting that target calibration is difficult for Remuneration Committees to get right. Finally, while not directly based on CEOs, there is evidence that metric-driven incentives (though, in principle, also true of equity incentives) can crowd out creativity and intrinsic motivation and thereby actually harm purposeful outcomes.¹⁹⁵

So where traditional incentives have a place, the measurement systems should be balanced, between growth, returns and risk, and between financial and non-financial. Measures linked to strategy and purpose can play an important role in providing a route-map to change as well as a communication tool for internal and external stakeholders.

But the problems of metric-driven incentivisation remain, for all the reasons outlined in this section. As a result they should probably play a relatively modest role compared with long-term equity holdings. The returns from a single year's bonus should be outweighed by the impact of decision making on the long-term value of the executive's stock. This requires a careful relative calibration of bonus awards, stock grants, and shareholding requirements.

So where does this leave us?

Efforts to reform executive pay should not focus in isolation on compensation alone, but recognise wider interactions. Managers are understandably fearful of dismissal, the risk of which is significant and increasing over time, and so focus on short-term survival – even if reward systems try to focus on the long term. Lengthening vesting periods may actually compound problems if managers behave in a myopic manner to avoid the risk of dismissal until their equity has vested.¹⁹⁶ This argues for allowing equity to vest in a reasonable timeframe but require it subsequently to be held by the executive for a period of time. Long vesting and holding periods may also expose managers to additional risk outside their control, in compensation for which they may demand greater pay, creating obvious political difficulties.

¹⁹⁵ Deci, E., Koestner, R. and Ryan, R. (1999) 'A Meta-analytic Review of Experiments Examining the Effects of Extrinsic Rewards on Intrinsic Motivation', *Psychological Bulletin* 125, 627–668. Grant, A. and Singh, J. (2001) 'The Problem with Financial Incentives – and What to do About It', *Knowledge@Wharton*. <http://knowledge.wharton.upenn.edu/article/the-problem-with-financial-incentives-and-what-to-do-about-it/>

¹⁹⁶ Laux, V. (2012) 'Stock Option Vesting Conditions, CEO Turnover, and Myopic Investment', *Journal of Financial Economics* 106, 513–526; Lund, A. and Polsky, G. (2013) 'Can Executive Compensation Reform Cure Short-Termism?', *Brookings Issues in Governance Studies* 58. Cziraki, P. and Groen-Xu, M. (2014) 'CEO Job Security and Risk-Taking'; LSE FMG Discussion Papers, DP 279.

Competition for talent is real and cannot be ignored by Remuneration Committees. Short tenure can encourage managers to seek incentives that focus excessively on what is measurable and controllable, shunning tasks with a purposeful dimension or long term pay off.¹⁹⁷ Competition can also set off ripple effects through the rest of the executive labour market: if one firm overpays its executive or relaxes its pay structure – perhaps due to weak corporate governance – this may spill over and lead to other firms doing so to remain competitive, even if they are managed purposefully.¹⁹⁸

In this environment it is particularly important for companies to stick to principles of purposeful compensation. Of course executives may place a discount on long-vesting equity compared with short-term cash. But better to pay more in a way that is aligned with long-term value than to dilute the pay principles in a way that could encourage short-term behaviour. Any additional pay needed to compensate the executive for longer vesting is outweighed by the potential benefits in terms of superior decision-making. Median CEO pay for a FTSE 100 firm is £5 million, or 0.07% of value compared to the median market cap of £7 billion. The benefits of (say) investing in employee satisfaction, are 2-% per year, i.e. £140-210 million. Moreover, the evidence is that CEOs voluntarily hold onto equity even after it has vested – in the U.S., the mean (median) CEO of a Russell 3000 firm holds \$70 million (\$13 million) of already-vested equity. This suggests that CEO risk aversion is not prohibitively high: since they are already wealthy, making them wait until their equity vests is not so costly. This requires strength of commitment from Remuneration Committees in face of pressure from executives and investors to do what is in the best long-term interests of the company.

Linked concerns about inequality, short-termism, lack of link between pay and performance risk bringing executive pay back into the regulatory spotlight. In Chapter 5 we bring together the options for change – on lengthening vesting periods, paying in debt, and introducing purpose based performance metrics – which together would represent a significant reorientation of the conventional executive pay package. High leverage should be the exception rather than the rule. The aim would be to create simpler pay packages that enabled executives to ‘get rich slow’ more as engaged owners than as ‘get rich quick’ short-term investors. Given the inflammatory salience of executive pay and the unintended consequences that regulation to correct it often brings, it would be better if companies and investors embraced change before having it forced upon them

Conclusion

In summary, the presence of right-sized, external non-affiliated blockholders across the world works well in promoting purpose, investment and innovation – and leans against the

¹⁹⁷ Holmstrom, B. and Milgrom, P. (1991) ‘Multitask Principal–Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design’, *Journal of Law, Economics, and Organization* 7, 24–52.

¹⁹⁸ Gabaix, X. and Landier, A. (2008) ‘Why has CEO Pay Increased So Much?’, *Quarterly Journal of Economics* 123, 49–100.

global trends to shorter holding periods for shares and the emergence of a very transaction oriented asset management industry. These trends are especially acute in Britain where regulatory and legal structures mean it is particularly exposed without offsetting patterns of blockholding. Recent trends in the pattern of share ownership, the structure of the asset management industry and the inadequate capabilities of asset owners have made matters worse.

Of course there are trade-offs between alternative forms of ownership, and different arrangements are suited to the particular circumstances and activities of companies. But in Britain the presumption that dispersed shareholdings and strong investor protection are the preconditions for both a flourishing stock market and strong corporate sector is wrong. Britain needs to find ways of promoting blockholding along with incentives to long-term value generation, including executive pay where remuneration should be better keyed to purposefulness and engaged ownership. The British ecosystem is unkind to investment in R&D and intangibles with macroeconomic consequences – the subject of the next chapter.

4. Stock markets, investment and productivity

To recap the argument so far, great companies that create value over time are mobilised by a unifying sense of purpose that allows all the companies' constituents to understand the trade-offs that are being made to further value generation. The concern is that the British ecosystem over-emphasises the interests of shareholders-as-short-term investors over all other stakeholder interests, including the role as shareholder as steward and engaged owner.

Commitment devices and blockholding prevailing in other countries allow commitment and purpose better to be expressed, and thus the role of shareholders as engaged owner. None are magic bullets; all involve risks and costs alongside opportunities and benefits. However Britain has so over-celebrated shareholder primacy that the complex trade-offs are all made in one direction; consequently purpose, and with it engaged ownership, are much harder to express.

This has become more important in the 21st century economy in which intangible investment is playing an ever-greater economic role in services, manu-services (the fusion of high-tech manufacturing and services) and high tech manufacturing. However investment in intangible assets, where the iterative marshaling of knowhow is central to success, is more reliant on trust relationships. Moreover returns tend to be even more long term and thus susceptible to damaging mis-valuation by stock markets with their tendency to be myopic. Over the recent past, UK productivity growth has weakened quite dramatically. Devising ways for corporate purpose to be better expressed is thus the key to enable UK companies better to invest in this new environment, and for the UK economy to prosper and compete globally. In this chapter we unpack these linkages and examine Britain's record, before turning to potential options for re-orienting the firm in Chapter 5.

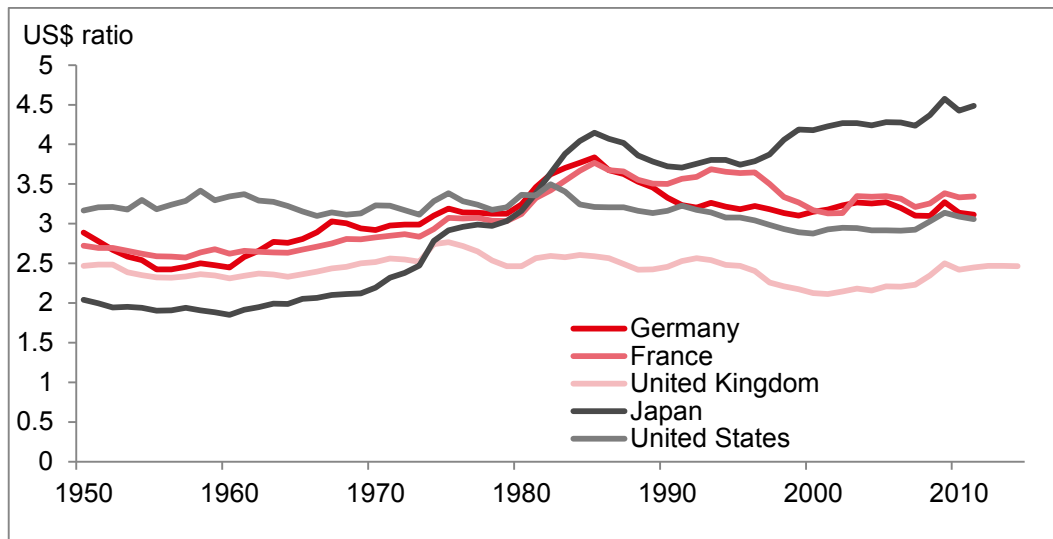
UK investment in tangible and intangible assets – is it below par?

The UK's tangible capital investment record is a long-standing weakness; with investment levels as a share of GDP historically lower than those of France, Germany and Japan. The composition of UK investment is also an issue, which is biased to real estate at the expense of capital equipment, which embodies newer technologies.¹⁹⁹ It has also had a structurally lower capital-to-output ratio than other advanced economies ever since the oil shock of the 1970s, as the graph below shows. Moreover the gap has been widening. This is normally taken as an open and shut case of underinvestment in tangible capital. But other

¹⁹⁹ LSE (2013) 'Investing for Prosperity: Skills, Infrastructure and Innovation', *Report to the LSE Growth Commission*.

explanations are available. The UK may be more efficient as it can generate the same output with less capital. Different countries have different economic structures, also explaining some of the difference. For example the UK has a relatively flexible labour market, which decreases the relative cost of labour to capital, and has a larger service sector, which is less capital-intensive than manufacturing.

Figure 4.1: Capital to output (1950–latest)^(a)

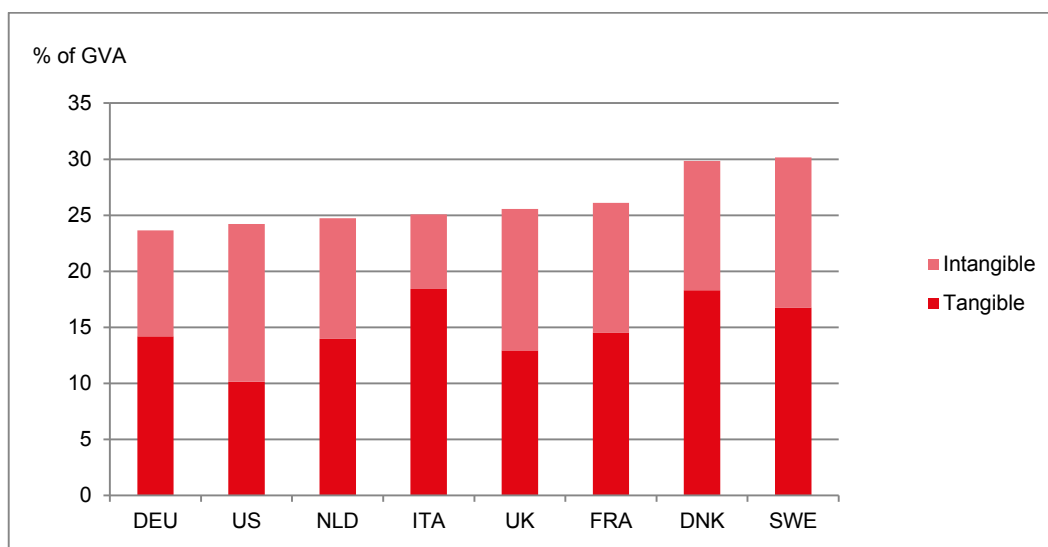


Source: Centre for International Data, ONS and Bank of England; modified from Bank of England Discussion Paper “Understanding and measuring finance for productive investment” (2016) (a) UK data for 2012–2014 updated using Bank of England estimates (see Oulton and Wallis (2015)). Capital to output ratio is the total economy capital stock (at replacement cost) over GDP.

In particular if intangible capital is included the UK is less of a conspicuous outlier. Figure 4.2 below shows total capital as a percentage of market sector²⁰⁰ gross value added (GVA) between 1995 and 2010. The average total capital share of the UK is similar to the US and most European peers, although lower than Scandinavian countries such as Denmark and Sweden. Perhaps the UK is doing less badly than the usual headline figures suggest.

²⁰⁰ The market sector excludes the public sector, private delivery of public services such as education and health, and the real estate sector (following Corrado, C., Haskel, J., Jona-Lasinio, C. and Iommi, M. (2012) ‘Intangible Capital and Growth in Advanced Economies: Measurement Methods and Comparative Results’.

Figure 4.2: Total (tangible and intangible) market sector GVA shares (average between 1995-2010)



Source: INTAN and Llewellyn Consulting. (a) Average between 1995 and 2010 as a proportion of 'market' sector GVA. Tangible assets exclude residential capital. The market sector excludes certain goods and services produced by the government (e.g. public services such as health and education) and households (e.g. childcare and housework). Modified from Bank of England Discussion Paper "Understanding and measuring finance for productive investment", 2016.

That is not to underplay the crucial role of investment in tangible assets for the long-run growth and productivity of an economy.²⁰¹ But the nature of investment has changed over recent years. In the 20th century, firms were predominantly capital-intensive and competed on cost efficiency. Companies with the most efficient *tangible* assets (such as land, machines, raw materials, and buildings) could manufacture goods more cheaply than their rivals, and became market leaders.

The 21st century firm is different. Nowadays, competitive success depends increasingly on product quality and innovation. Tangibles in the form of information communication technology (ICT) investment remain important: indeed they still contributed around 60% of productivity growth in services across the EU between 1997-2007. But they are increasingly dependent on a company's *intangible* assets, such as its human capital and R&D capabilities.²⁰² Thus, an analysis of Fortune 500 companies shows that in 1975, 60% of their market value was represented by their tangible assets. However, 20 years later this percentage had fallen to just 25%.²⁰³

²⁰¹ Haskel, J. (2015) 'Intangibles and Growth in OECD Countries'.

²⁰² For the complementarities between ICT and intangibles, see Bresnahan, T., Brynjolfsson, E. and Hitt, L. (2002) *Quarterly Journal of Economics* 117, 339–376.

²⁰³ Bloom, M. (2008) 'Double Accounting for Goodwill. A Problem Redefined'; Routledge.

This shift from tangible to intangible investment is important. Tangible assets are visible in the short-term – for example, investors can see if a firm has bought a brownfield plant, or is in the process of constructing a greenfield one. Moreover tangible assets can be capitalised on the firm’s balance sheet: this may not fully persuade investors to be less myopic, especially where high build or sunk costs are involved, but it goes some way.

In contrast, the obstacles to intangible investment being valued properly are even greater. Returns may take several years to appear. The quality of a firm’s workforce or innovative capabilities is difficult for investors to observe, and it will only manifest in the future when they start to translate into bottom-line earnings. To the extent the stock market is myopic, it is unable to forecast the positive impact of intangible investment on future earnings, and only takes into account its negative impact on current earnings. While tangible investments are typically capitalised and thus do not lower a firm’s profit, most intangible investments – notably and employee training – are expensed and show up as costs rather than capital investment. It is for that reason that they are particularly vulnerable to cuts when CEOs are anxious to boost short-term earnings, as a large volume of research on R&D spending shows.

This dilemma cuts across all sources of financing: Big Innovation Centre’s own research also reveals an unwillingness of banks to lend against intangible assets, suggesting the problem goes beyond the capital markets capacity to value intangibles. High-growth firms have 74% more intangible assets and intellectual property on their balance sheet than their slower growing counterparts, but face greater difficulties than the rest in accessing growth finance due to their assets being mainly intangible.²⁰⁴

EY also observe that lack of awareness of the value of intangibles is pervasive in British business life: they are not part of executives’ natural language while investors struggle to ask informed questions about them. To the extent they are managed, they sit with intellectual property (IP) teams within legal departments, which are several layers down from the executive. The concept of ‘goodwill’, which recognises only intangible assets that have been acquired, does not unpack their current depth, complexity and importance – thus reinforcing the tendency not only of the investment community but managements to neglect this crucial resource.

Policymakers hope to this end that accounting and financial reporting initiatives will bring standards into the 21st century. How far is this hope justified? Since 2014, R&D has been capitalised and included as part of gross fixed capital formation in the UK national accounts.

²⁰⁴ See for example: (i) Sameen, H. and Quedsted, G. (2013) ‘Disrupted Innovation: Financing innovative small firms in the UK’, Big Innovation Centre; (ii) Sameen, H. (2013) ‘Two spheres that don’t touch’, Big Innovation Centre; (iii) Lee, N., Sameen, H. and Lloyd, M. (2013) ‘Credit and the Crisis: Access to finance for small innovative firms’, Big Innovation Centre. For an overview of how IP valuations are used for business strategies see: Andersen, B. (ed.) (2006) ‘Intellectual Property Rights: Innovation, Governance and the Institutional Environment’; Edward Elgar Publishing.

However, progress has been slower at a firm-level. For example, International Accounting Standard 38 has stringent criteria for R&D – or any intangible expense to be capitalised. In the US, the Statement of Financial Accounting Standards ('SFAS') Rule 2 expenses R&D “due to the uncertainty associated with future economic benefits”.²⁰⁵

Regulators and experts with long memories are aware that these are not new debates. Similar issues have been examined in the past only to become bogged down in technical quicksand: for instance, should the value of intangibles be calculated on the basis of how much they cost to create or should management?

The drive to incorporate more and more information into financial statements may offer rapidly diminishing returns. Baruch Lev reports that of the estimated 150 standards issued by the Financial Accounting Standards Board (FASB) since its establishment in 1973 to 2009, 75% had zero impact on the shares of the impacted companies: indeed, 13% of the 12% actually lowered shareholder value and only 12% made a positive difference.²⁰⁶

Treating intangibles as traditional accounting items may further add to this noise. By itself, a piece of off-the-shelf software is both *inert* – it neither creates value nor generates growth and is heavily *commoditised* – it can be readily accessed by other companies. To come to life, it must be integrated with other complementary organisational assets that enable the company to generate a competitive advantage and sustainable cash flows. Lev's recommendation is that companies focus on more forward-looking information: in addition to financial statements, they should report on the overall value creation system of the organisation along with operational and intangible KPIs (e.g. product pipelines, order backlogs, customer acquisition costs and churn) via supplemental corporate reports – in effect disclosing their path to growth.²⁰⁷

Purpose, in this respect, is the supreme organisational asset. Purposeful companies engage their employees, customers, suppliers, and communities in the ways we have described in Chapter 1. It is the emphasis on purpose – the pursuit of long-term, sustainable value underpinned by a narrative of what purpose the company serves – rather than immediate returns – that is critical for inducing intangible investment and its proper reporting and valuation. Big Innovation Centre is already working on a follow up study – 'Intangible Gold' – to examine in more detail these issues, along with their linkages to productivity.

²⁰⁵ Exceptions that can be capitalised include tangible assets acquired for R&D activities that have alternative future uses, as can the costs of computer software that is to be sold, leased, or otherwise marketed, after the technological feasibility for the product is established.

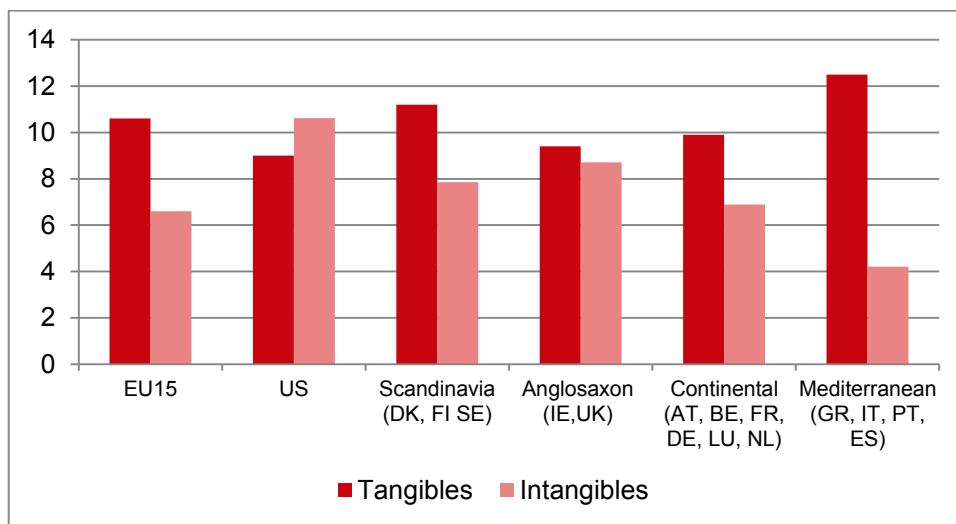
²⁰⁶ Lev, B. and Rajgopal, S. (2 March 2016) 'Why the FASB Should Hit Pause', *Accounting Today*.

²⁰⁷ Lev, B. and Daum, J. (2004) 'The Dominance of Intangible Assets: Consequences for Enterprise Management and Corporate Reporting', *Measuring Business Excellence* 8, 6–17 and Lev, B. (2012) 'Winning Investors Over: Surprising Truths About Honesty, Earnings Guidance and Other Ways to Boost Your Stock Price'; Harvard Business Review Press.

Intangibles in the UK

The increasing importance of intangible investment is particularly pronounced in the UK, a potential source of reassurance. Over the past two decades, UK investment in intangibles has both grown rapidly and has had the highest propensity to invest in intangible assets relative to tangibles out of its European peers (Figures 4.3). The relative importance of intangibles is highest in the US.

Figure 4.3: Tangible vs. intangible GDP shares (average between 1995–2009)

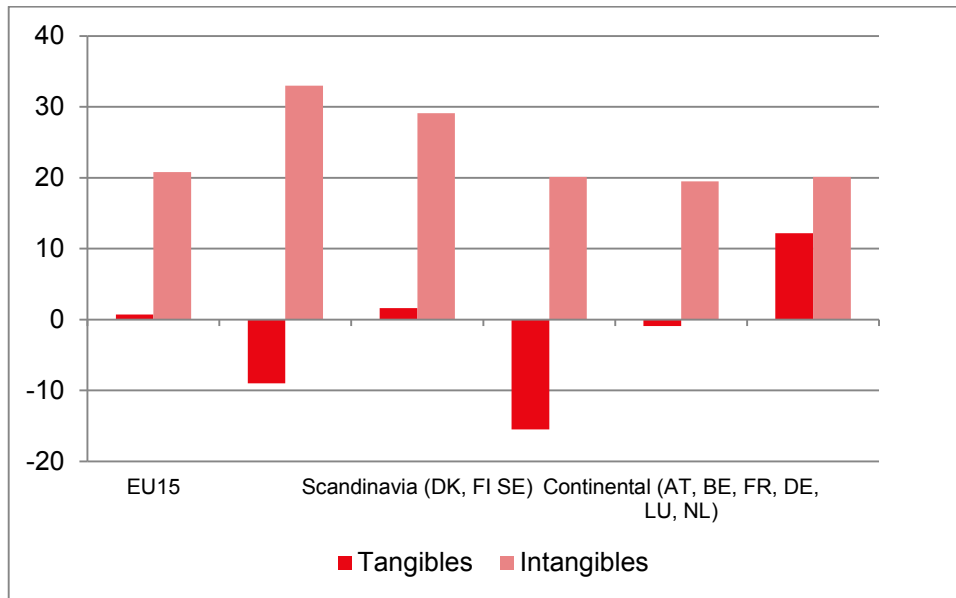


Source: Corrado, Haskel, Jona-Lasinio and Iommi (2013)²⁰⁸

However, Scandinavian countries in particular have started to catch up in terms of intangibles as a share of total GDP, with this figure growing more quickly than in the UK over the past two decades, (Figure 4.4). Figure 4.4 also shows that the decrease in tangible investment as a percentage of GDP has been greatest in the UK over this period. So, overall intangible assets are already an important source of economic growth for the UK, and are likely to play an even greater role in the future.

²⁰⁸ Corrado, C., Haskel, J., Jona-Lasinio, C. and Iommi, M. (2013) 'Innovation and Intangible Investment in Europe, Japan and the US'; Imperial College Business School Discussion Paper 2013/1.

Figure 4.4: Tangible vs. intangible GDP shares (% change between 1995–2009)

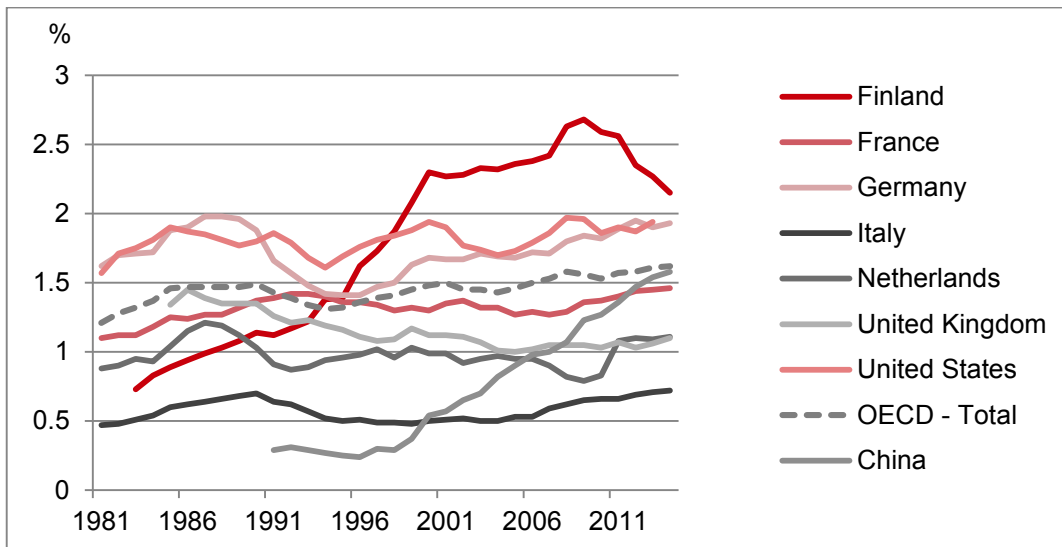


Source: Corrado, Haskel, Jona-Lasinio and Iommi (2013). Note that the figures refer to per cent changes, not percentage point changes.

However the position is less reassuring if we focus on R&D investment – one of the most crucial components of intangible investment from both an economic and policy perspective.²⁰⁹ Figure 4.5 below compares corporate R&D investment (as a percentage of GDP) in the UK versus other OECD countries and China. While the UK’s level was slightly above average in 1985, it has declined gradually over time, whereas every other country has experienced a rise. As a result, the UK’s current level of R&D investment is significantly below average – despite the relative importance of intangibles to the UK.

²⁰⁹ Frontier Economics (2014) ‘Rates of Return to Investment in Science and Innovation’, A Report Prepared for the Department for Business, Innovation and Skills.

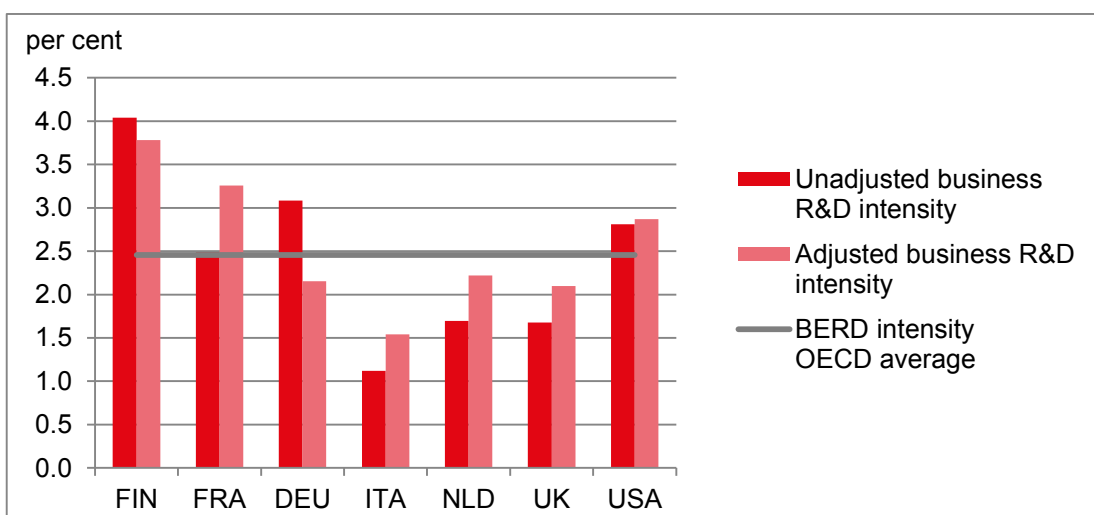
Fig 4.5: Business expenditure on R&D relative to GDP, 1981–2014



Source: Based on OECD Main Science and Technology Indicators data

The UK's low level of R&D compared to other countries can be explained partly because Britain has an economic structure with a large service sector and a moderate presence in research-intensive manufacturing. Importantly, however, even adjusting for different sectoral structures as in Figure 4.6, the gap is only partly closed. The UK remains a below average investor.

Fig 4.6: Business expenditure on R&D relative to GDP (unadjusted and adjusted for sectoral composition of GDP), 2013^(a)



Source: Modified from OECD Main Science and Technology Indicators 2015 (Figure 5.1.1)

(a) A country's industrial structure-adjusted indicator of R&D intensity is a weighted average of its sectoral R&D intensities (ratio of R&D to value added), using the OECD industrial structure – sectoral share in OECD value added for 2013 – as adjusted, common weights across all countries.

This has important knock-on consequences: R&D is not just important for the particular firm or sector, but for the wider economy. Studies have found that the spillovers on productivity, from the diffusion of knowledge, are greater from intangible investment than from tangible investment.²¹⁰ For example singling out R&D,²¹¹ Hall, Mairesse and Mohnen (2010) provide an overview of these estimates and conclude that social returns to R&D are higher than private returns to R&D, which in turn are higher than for ordinary capital investment. For instance, studies by Mansfield et al. (1977) and Tewksbury et al. (1980) found a median social rate of return of 50-100%, compared to a median private return of around 25%.

Corrado, Haskel, and Jona-Lassinio (2014)²¹² reinforce the case, highlighting complementarities between tangible and intangible assets. For example, adoption of information and communication technology (ICT) requires training workers on ICT usage. They find that returns to a country's investments in intangible capital are stronger in ICT-intensive industries, and that investments in workforce skills and intangible capital generate positive spillovers to productivity growth. These spillovers are likely to become increasingly important given structural trends towards services, automation and higher-end manufacturing (including 'manual services' which blur the boundaries between manufacturing and services), for which human capital and other intangible assets are particularly critical.²¹³

Thus, any underinvestment in intangibles at the individual firm level has the potential to lead to even greater underinvestment at the aggregate economy level, and thus endanger the UK's success in global competition. Moreover, the existence of these spillovers means that the returns to investment, in particular in intangible forms, are often under-estimated. In particular, increases in output may be misclassified as stemming from improvements to total factor productivity when the true source is capital deepening (i.e. investment). Finally, note that investment in intangibles extends above and beyond what can be captured by measures such as R&D expenditure.

²¹⁰ See Hall, Mairesse and Mohnen (2010) 'Measuring the returns to R&D', *Handbook of the Economics of Innovation 2*, for a survey of results for R&D investment.

²¹¹ Goodridge, P., Haskel, J. and Wallis, G. (2014) 'Spillovers from R&D and Other Intangible Investment: Evidence from UK Industries'; NESTA Working Paper. They find that spillovers (based on lagged changes in other industry knowledge stocks) are higher for R&D than for total intangibles (excluding R&D) (both are statistically significant and largely robust to different weighting schemes); however, they are unable to determine which non-R&D intangible asset(s) are driving the latter result. Only economic competencies are found to be significant (though only at the 10% level using one weighting scheme) and have considerably lower spillovers than R&D. One tentative interpretation, in the absence of a longer and wider dataset, is that spillovers arise from the bundle of non-R&D intangible investments not just each element.

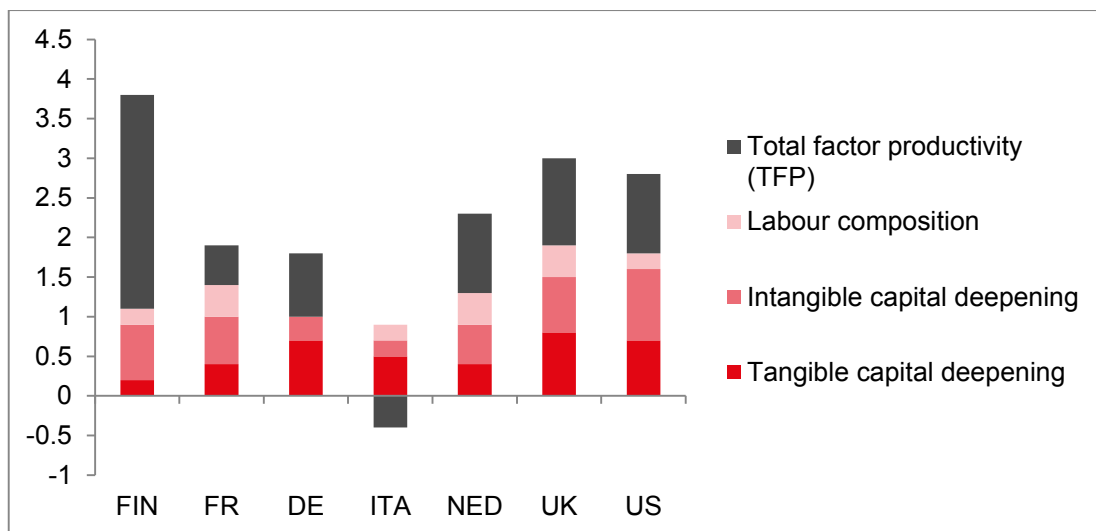
²¹² Corrado, C., Haskel, J. and Jona-Lasinio, C. (2014) 'Knowledge Spillovers, ICT and Productivity Growth'; IZA Discussion Paper No. 8274.

²¹³ See, e.g. McKinsey Global Institute (2012) 'Manufacturing the Future: The Next Era of Global Growth and Innovation'.

Productivity

Productivity growth is also affected by investment trends. Figure 4.7 below, based on analysis by Corrado et al. (2013), show that both intangible and tangible capital deepening are relatively important for UK productivity growth. Intangible capital accounts for 23% of UK labour productivity growth between 1995 and 2007 and 32% for the U.S.²¹⁴ In addition, the importance of total factor productivity is also high, and may reflect spillovers from investment which are mis-classified into this category, as explained earlier. The authors conclude that “Drawing this together we have the following. First, the UK, like the US now has more intangible investment than tangible investment, and other EU countries are following. That is to say, future investment will look much more intangible than tangible. Second, this investment is important for growth. In the US, capital deepening is 65% of growth and intangible investment is now 50% of capital deepening. EU countries will be catching up to this level.”

Figure 4.7: Contributions to the growth of output per hour (labour productivity), 1995–2007 (annual changes, in %)



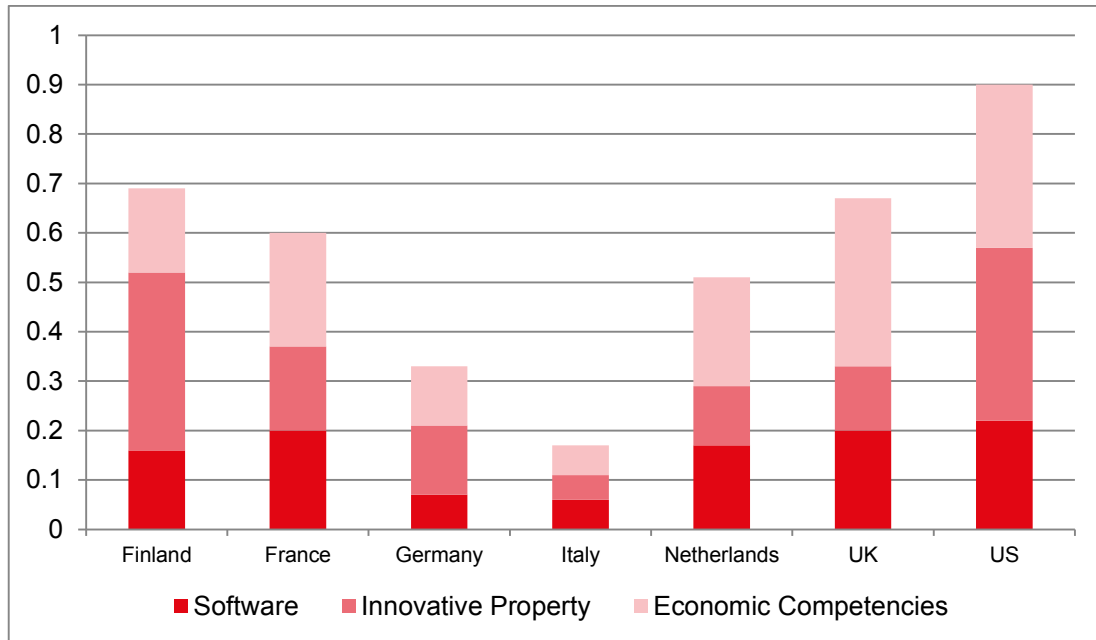
Source: Based on Table 2 in Corrado, Haskel, Jona-Lasinio and Iommi (2013)

While Figure 4.7 studies the importance of intangible capital deepening in total, Figure 4.8 below decomposes this total into three categories: software, innovative property (which includes R&D and design), and economic competencies (which includes advertising, organisational capital and training). It shows that, while the total level of intangible capital deepening is of similar importance between the UK, US, and Finland (Figure 4.8), economic competencies are particularly important in the UK (Figure 4.8). The decomposition of

²¹⁴ Based on Corrado, Haskel, Jona-Lasinio and Iommi (2013).

intangibles into these categories is potentially important if the degree of spillover and stock-market myopia varies across categories. It may be that the UK's intangible investment is skewed to areas where spillovers are fewer – a fruitful area for future research.

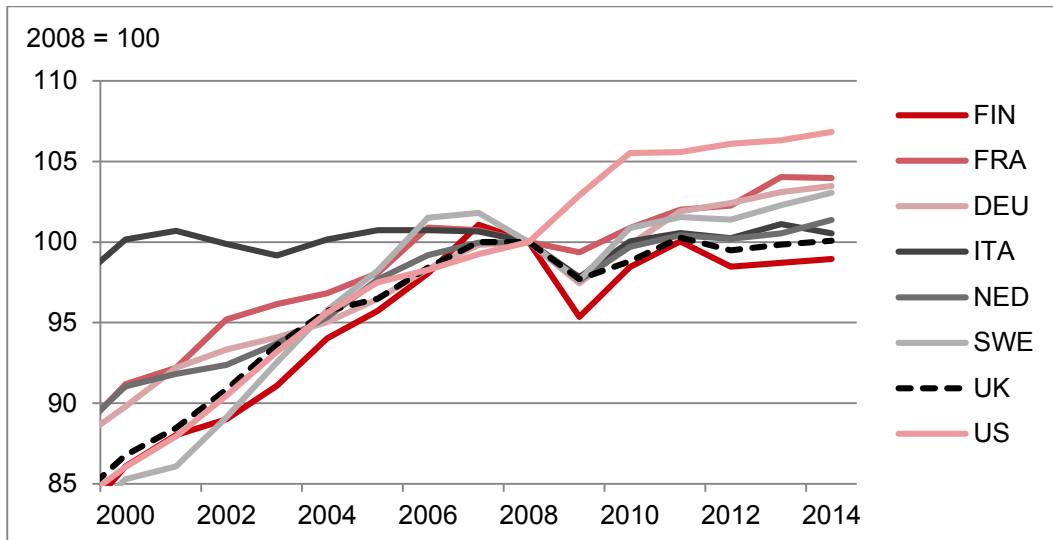
Figure 4.8: Contribution of categories of intangibles to labour productivity growth (1995–2007)



Source: Corrado, Haskel, Jona-Lasinio and Iommi (2013)

This raises the critical question whether underinvestment is responsible for low productivity growth in recent years. Figure 4.9 compares labour productivity growth before and following the 2008-09 crisis across a range of advanced economies. Since 2008, the UK has underperformed France and Germany by around 3-4% cumulatively, and the U.S. by about 7%. In particular, while pre-crisis productivity growth was similar between the UK and the US, it has recovered much more strongly in the US following the crisis.

Figure 4.9: Growth in output per hour worked, 2000–2014 (indexed to 2008)



Source: OECD, authors' calculations

The gap for the UK between the growth on productivity before and after the financial crisis has been dubbed the *UK productivity puzzle*.²¹⁵ Goodridge et al. (2015)²¹⁶ estimate a productivity gap of 12.6% in 2011, based on pre-crisis trend growth of 2.5% per year between 2000 and 2007. They find that lower (tangible and intangible) capital deepening can only account for about 5% of this gap, while labour reallocation (from less productive to more productive industries and vice versa) explains a negative amount, and so most of the gap must stem from a slowdown in TFP growth. They estimate that one third of this 'TFP gap' can be explained by structural weakness in TFP growth in the oil and gas and financial services sectors, and another 1/6 to 1/3 by premature capital scrapping, with the remainder unexplained.

While this suggests that the productivity slowdown is not the consequence of insufficient investment, the authors go on to suggest that it might still be consistent with a longer-run fall in R&D spending. Thus, R&D spending fell from the 80s (which grew at 4.6% p.a. in 1980–90), to 2.1% p.a. growth in 1990–2000, and 2.2% p.a. in 2000–10. They argue that if the spillovers from R&D materialise within a decade, the slowdown in R&D from the 80s to the 90s would be captured in a slowdown in TFP growth in the 90s (1.34% p.a., compared to 2% p.a. in the 80s). But if the spillovers take even longer to pass through, then the decrease in positive R&D spillovers may explain part of the recent slowdown in TFP and productivity growth. A concern of this report is that the weakening of the capacity of companies to express purpose over the last three decades has expressed itself in the decline and R&D

²¹⁵ See e.g. Barnett, A., Batten, S., Chiu, A., Franklin, J. and Sebastiá-Barriel, M. (2014) 'The UK productivity puzzle', *Bank of England Quarterly Bulletin* 2014 Q2.

²¹⁶ Goodridge P., Haskel, J. and Wallis, G. (2015) 'Accounting for the UK Productivity Puzzle: A Decomposition and Predictions'; Imperial College Business School Discussion Paper 2015/02.

spending, exhibiting itself in slowing productivity growth.

In conclusion, the trend of British investment, even taking into account the relative strength of intangibles, is a cause for concern. In particular, the recent rate of investment in R&D is below-average, even when accounting for the sectoral composition of the UK economy, and this may explain why productivity growth has been so slow to recover after the financial crisis.

Is the stock market myopic?

In an efficient stock market, the share price is forward-looking. It captures the present value of all future dividends, discounted at a rate that reflects both risk and the time value of money. Thus, it should take into account every asset (and liability), both tangible and intangible, that affects the firm's ability to generate earnings and thus pay dividends, both now and in the future. For example, even if a firm's high level of employee engagement or innovative capability will not feed through to earnings and dividends until many years' time, they should be captured in the share price today since the market should forecast their future benefits.²¹⁷

However, in practice, there is significant evidence suggesting that the stock market is myopic. Such myopia may stem from either from over-forecasting of the discount rate or under-forecasting of dividends. Starting with the first channel, Poterba and Summers (1995) surveyed CEOs at Fortune-1000 firms and found that the discount rates applied to future cash-flows (the weighted average cost of capital) were around 12%. Since this discount rate is a weighted average of debt and equity, it implies a cost of equity exceeding 12%, whereas equityholders' historical realised rate of return is in the single digits.²¹⁸ This problem of excessive discounting may be particularly the case for cash flows that arise in the future. Davies, Haldane, Nielsen and Pezzini (2014) show that shareholders may exhibit a tendency to discount excessively, and that this tendency has become stronger in the decade to 2004 compared to the previous decade.²¹⁹

Moving to the second channel, several academic studies suggest that the stock market undervalues intangible assets that have the potential to generate future dividends – even though these intangible assets are public information. This undervaluation is evidenced by

²¹⁷ Note that an efficient market does not mean that the stock price is always correct *ex post*. Finding that a firm ends up growing faster than its prior stock price implied – and thus that the firm was previously underpriced – does not suggest market inefficiency, as this rapid growth may be due to positive shocks that could not be predicted at the time. Instead, it means that the stock price is unbiased: based on all available information at the time, the stock price equals the discounted expected value of all future dividends. Stocks should be just as likely to outperform subsequently as they are to underperform.

²¹⁸ Poterba, J., and Summers, L. (1995) 'A CEO Survey of US Companies' Time Horizons and Hurdle Rates', *Sloan Management Review* 37, 43–43.

²¹⁹ Davies, R., Haldane, A., Nielsen, M. and Pezzini, S. (2014) 'Measuring the costs of short-termism', *Journal of Financial Stability* 12, 16–25.

firms with high intangibles subsequently outperforming their peers – if the market were efficient, these intangibles would already be priced in, and so firms with high intangibles would not subsequently outperform.

For example, as we report in Chapter 1, Edmans (2011, 2012) shows that companies with high employee satisfaction – as measured by inclusion in the list of the ‘100 Best Companies to Work For in America’ – delivered stock returns that beat their peers by 2.3%–3.8%/year over 1984-2011.²²⁰ In addition, the Best Companies deliver future earnings that systematically outperform analysts’ expectations. Moreover, it takes the stock market 4-5 years before it fully incorporates employee satisfaction into stock prices, even though the list is highly public. Edmans, Li, and Zhang (2015) extend the analysis to 14 countries worldwide and show that the returns to employee satisfaction continue to hold in countries with flexible labour markets, such as the UK.²²¹ The market similarly appears to undervalue other measures of CSR – and thus also purpose – such as customer satisfaction and environmental responsibility.

Turning to more traditional measures of intangibles, patent citations,²²² R&D and advertising,²²³ and software development costs²²⁴ are also not immediately incorporated into stock prices, and thus lead to superior long-run returns. Even though R&D can be recorded separately on the income statement, the level of R&D is uninformative of its quality and so R&D may be under-priced. Investors do not know whether high R&D results from desirable investment, managers’ failure to take tough decisions and curb ‘pie-in-the-sky’ projects, or its current product portfolio becoming obsolete. Moreover, even when the quality of R&D can be inferred, the stock market may still not take it into account.²²⁵ In the accompanying box we set out further evidence of myopia as documented in a variety of different corporate contexts.

²²⁰ Edmans (2011, 2012) op. cit.

²²¹ Edmans, A., Li, L. and Zhang, C. (2015) op. cit.

²²² Deng, Lev, and Narin (1999), op. cit.

²²³ Chan, Lakonishok, and Sougiannis (2001) ‘The Stock Market Valuation of Research and Development Expenditures’, *Journal of Finance* 56, 2431–2456.

²²⁴ Aboody, D. and Lev, B. (1998) ‘The Value Relevance of Intangibles: The Case of Software Capitalization’, *Journal of Accounting Research* 36, 161–191.

²²⁵ Bushee (1998) ADD finds that investors who trade on earnings induce managers to cut R&D to meet earnings targets. Roychowdhury (2006) ADD shows that firms manipulate earnings through real activities, including cuts in discretionary spending, to avoid reporting losses. Bhojraj, Hribar, Picconi, and McInnis (2009) ADD find that firms that beat analyst consensus forecasts by reducing discretionary spending enjoy a short-term stock price gain that is reversed in the long-run. Bushee, Brian J. (1998) ‘The influence of institutional investors on myopic R&D investment behavior’, *The Accounting Review* 73, 305–333.

Bhojraj, S., Hribar, P., Picconi, M. and McInnis, J. (2009) ‘Making sense of cents: an examination of firms that marginally miss or beat analyst forecasts’, *Journal of Finance* 64, 2361–2388.

Roychowdhury, S. (2006): ‘Earnings management through real activities manipulation’, *Journal of Accounting and Economics* 42, 335–370.

Myopia – the evidence surveyed

Survey evidence

In a highly cited study, Graham, Harvey, and Rajgopal (2005) surveyed CFOs of 401 U.S. firms and found that 78% admitted to sacrificing long-term value to smooth earnings. 80% would decrease discretionary expenditure on R&D, advertising, and maintenance to meet an earnings target, and 55% would delay starting a new project to meet an earnings target, even if such a delay reduced value.²²⁶

Stock-Based Compensation

Edmans, Fang, and Lewellen (2016) study the incentives provided by stock-based compensation. They hypothesise that, when CEO expects to sell his shares on the stock market, he will reduce investment in order to temporarily boost earnings and thus the share price. However, simply demonstrating a negative correlation between CEO share sales and investment may be consistent with poor investment opportunities (an omitted variable) causing the CEO to both cut investment and sell his stock. Thus, the authors use the scheduled vesting of equity as an exogenous driver of equity sales. They find that vesting equity is significantly negatively correlated with same-quarter growth in both R&D and capital expenditure. Moreover, CEOs with more vesting equity are more likely to beat analyst earnings forecasts by a small margin (but not by a large one), suggesting that they are particularly concerned with meeting the earnings target. Ladika and Sautner (2014) similarly show that, the adoption of FAS 123R led to some firms accelerating option vesting, and that such accelerated vesting was associated with a fall in capital expenditure.²²⁷

Earnings Disclosure

Kraft, Vashishtha, and Venkatachalam (2015) study changes in the mandatory reporting frequency in the US. The Securities and Exchange Commission required annual reporting of financial statements in 1934, moved to semi-annual reporting in 1955, and finally to quarterly reporting in 1970. The authors compare firms affected by the law changes (i.e. who had to increase their reporting frequency to comply) with those unaffected, because they were already voluntarily reporting at the new required frequency before the law change. They find that a mandatory increase in reporting frequency leads to a reduction in fixed investment by 1.5-1.7% of total assets, 15-21% of the average level of investment. This reduction persists for at least five years.²²⁸ Ernstberger, Link, Stich, and Vogler (2015) found that the change from semi-annual to quarterly reporting under the 2004 EU Transparency Directive led to

²²⁶ Graham, J., Campbell, C. and Rajgopal, S. (2005) 'The Economic Implications of Corporate Financial Reporting', *Journal of Accounting and Economics* 40, 3–73.

²²⁷ Ladika, T. and Sautner, Z. (2014) 'Managerial Short-termism and Investment: Evidence from Accelerated Option Vesting'; Working Paper.

²²⁸ Kraft, A., Vashishtha, R. and Venkatachalam, M. (2015) 'Real Effects of Frequent Financial Reporting'. Working Paper.

firms reducing investment, which improved operating performance in the short term but lowered it in the long term.²²⁹

These findings have important implications for disclosure regulations. One response to the financial crisis and corporate scandals is to force firms to disclose more information. Doing so, the argument goes, will prevent them from taking destructive actions that are hidden from shareholders and regulators. Indeed, Sarbanes-Oxley, Regulation Fair Disclosure, and Dodd-Frank in the US have all increased disclosure requirements. However, regulation can only force disclosure of 'hard' (i.e. tangible, verifiable) information, such as a company's earnings. 'Soft' (i.e. intangible, unverifiable) information, such as the level of a company's employee engagement, cannot be credibly disclosed. Mandatory disclosure will induce companies to focus on hard information at the expense of soft – for example, by cutting investment to boost earnings²³⁰ – just as publicising pupils' test results may encourage teachers to teach to the test. Indeed, the 2013 EU Transparency Directive Amending Directive and the UK's amendment to the Disclosure and Transparency Rules in 2014 abandoned the requirement for interim management statements, stating that less frequent reporting would encourage long-term investment. However there is a balance to be struck: the recent collapse in the valuations of a number of high-profile unicorns – with some dryly predicted to become 'unicorpses' – suggests that the demands for regular public disclosure of information should not be abandoned altogether.²³¹

Credit Ratings

Credit ratings are a feature of firms whose *debt*, rather than equity, is trading on public markets. Thus, they can be a feature of firms whose equity is private, and they need not be a feature of public firms. Nevertheless, they are an example of how public markets' focus on short-term performance measures can lead to underinvestment.

Begley (2015) notes that a key input into a credit rating is whether a firm's Debt/EBITDA ratio is above or below certain thresholds (e.g. 2.0 or 3.0). Thus, firms with ratings close to a threshold have strong incentives to increase EBITDA (for instance, by reducing investment) and ensure they remain below the threshold. He finds that such firms are significantly more likely to reduce R&D and SG&A expenditures prior to bond issuance than firms far from a threshold. Moreover, these reductions have significantly negative long-term effects in terms of reduced numbers of patents, patent citations, profitability, and valuation ratios.²³² Readers

²²⁹ Ernstberger, J., Link, B., Stich, M. and Vogler, O. (2015) 'The Real Effects of Mandatory Quarterly Reporting'; Working Paper.

²³⁰ Edmans, A., Heinle, M. and Huang, C. (2016) 'The Real Costs of Financial Efficiency When Some Information is Soft', Review of Finance; Forthcoming; Gigler, F., Kanodia, C., Sapra, H. and Venugopalan, R. (2014) 'How Frequent Financial Reporting Can Cause Managerial Short-Termism: An Analysis of the Costs and Benefits of Increasing Reporting Frequency', *Journal of Accounting Research* 52, 357–387.

²³¹ Mooney, A. (3 April 2016) 'There are Going to be A lot of Dead Unicorns', Financial Times, <https://next.ft.com/content/9312e100-f71c-11e5-803c-d27c7117d132>. See also Moritz, M. (16 October 2015) 'The subprime 'unicorns' that do not look a billion dollars', Financial Times, <https://next.ft.com/content/91063628-73f5-11e5-bdb1-e6e4767162cc>.

²³² Begley, T. (2015) 'The Real Costs of Corporate Credit Ratings'; Working Paper.

should also recall the evidence assembled in Chapter 2 that on balance the threat of takeover means that management teams emphasise short term share price performance.

The view that stock markets are myopic has not gone unchallenged.²³³ Counter-arguments point to many companies being valued at several multiples of their book value, suggesting that intangible assets not on the balance sheet are clearly being recognised by investors. Based on recent valuations, GlaxoSmithKline is worth 14 times its book value; this ratio is 4 for Alphabet. Facebook's \$22bn bid for WhatsApp and Google's \$400m acquisition of the UK start-up DeepMind were primarily justified by their intangible assets such as brands and research capabilities. Some 'unicorns' (start-ups valued at over \$1 billion) do not make positive profit; more broadly, only 10-15% of the stock price of Dow Jones Industrial Average companies can be attributed to expected dividends over the next five years.

However, the existence of unicorns does not contradict stock market myopia. Unicorns' long-term prospects are typically evaluated according to quantitative measures, such as the number of users of an app. If valuations ignore qualitative measures of long-term prospects, such as corporate culture and sustainability, they are still myopic.

Most importantly, the key question is not whether stock markets *partially* incorporate the value of intangible assets (which is undisputed), but whether they *fully* do so. For example even if markets fully react to changes in current earnings (which is disputable), but only partially react to changes in future earnings prospects or growth in intangible assets (which is beyond dispute), then managers face distorted incentives to invest. In short there is a problem that needs to be addressed.

The Public Private Conundrum

The retreat from public equity markets with more firms choosing to stay private is further support to the concern that public markets malfunction. Ownership is much more concentrated in private firms, and large investors' sizable stakes give them incentives to monitor intangible assets, such as a firm's R&D portfolio or corporate culture. Cornelli, Kominek, and Ljungqvist (2013) find that private equity investors gather not only quantitative information on financial performance, but also qualitative information on the firm's operations and the CEO's competence.²³⁴ Likewise Bernstein (2015) reports a substantial decline in the quality of innovation and the departure of key talent following the decision of firms to go public.²³⁵ He documents a causal effect by studying firms that actually went public with those that planned to do so but were unable to due to for exogenous reasons – market volatility during the book-building phase.

²³³ Summers, L. (2012) 'Do Capital Markets Induce Corporate Myopia?'. Roe, M. (2013) 'Corporate Short-Termism – In the Boardroom and in the Courtroom', *Business Lawyer* 68, 977–1006.

²³⁴ Cornelli, F., Kominek, Z. and Ljungqvist, A. (2013) 'Monitoring Managers: Does it Matter?' *Journal of Finance* 68, 431–481.

²³⁵ Bernstein, S. (2015) 'Does Going Public Affect Innovation', *Journal of Finance* 70, 1365–1403.

Unlike private firms, public firms must report short-term earnings at high frequency. In the U.S., all public firms must report quarterly. The EU Transparency Directive of 2004 (implemented in the UK through the Financial Conduct Authority's Disclosure and Transparency Rules in 2007) required firms to produce interim management statements with an update on quarterly performance. However this framework has begun to be relaxed. The 2013 EU Transparency Directive Amending Directive removed the requirement for interim management statements from November 2015, and the UK's amendment to the Disclosure and Transparency Rules accelerated this removal to November 2014 for UK firms. However, many firms still choose to report quarterly earnings, in part due to pressure from investors. For example, as we wrote in Chapter 1, when Paul Polman of Unilever announced that he would stop reporting quarterly earnings, many investors sold their shares, reducing the stock price by 8% upon announcement.

Lastly and relatedly, public firms are frequently covered by equity analysts. Before each earnings announcement, equity analysts forecast a firm's earnings. Delivering earnings that miss the consensus forecast, even by a small amount, typically leads to a significant fall in the stock price; indeed, Terry (2014) estimates that such a fall reduces the CEO's compensation by 7%.²³⁶ The magnitude of this cost is self-reinforcing. CEOs know that the stock market punishes firms that miss the consensus. Thus, CEOs who are likely to miss consensus may take actions (efficient ones such as improving productivity or myopic ones such as reducing investment) to avoid doing so. As a result, the market knows that any CEO who misses consensus – despite being aware of the costs of doing so – must be in real trouble, since he likely attempted various actions to meet the target and still failed. While investors in private firms may also set targets for management, these targets are not exclusively in financial terms, as discussed previously.

One manifestation of these arguments is that private firms invest more. Figure 4.10 conducts a simple comparison between public and private firms in the UK, and finds that the latter have 4–5 times more capital assets for every pound of sales than public firms.²³⁷ Turning to R&D, Figure 4.11 from the 2010 BIS scoreboard finds that the R&D-to-sales ratio is lower among public than private firms.

²³⁶ Terry, S. (2012) 'The Macro Impact of Short-Termism'; Working Paper.

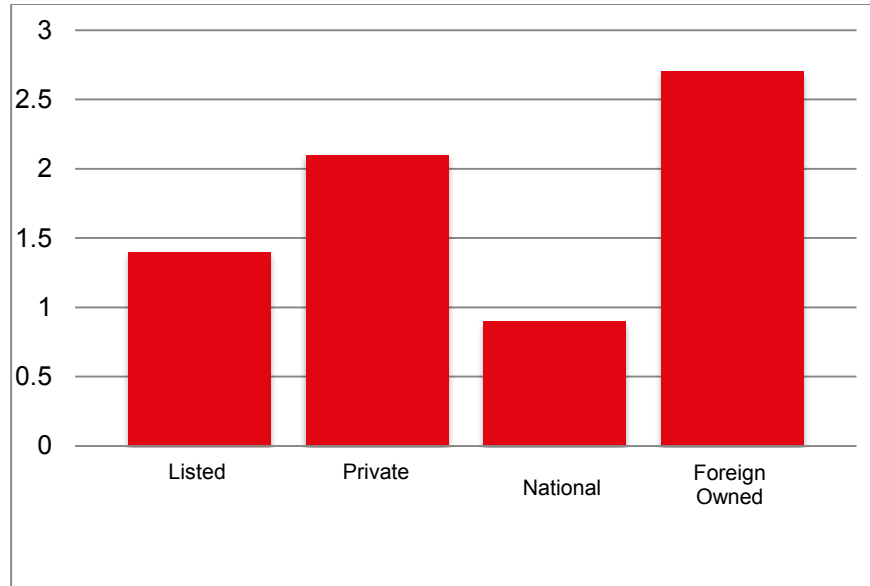
²³⁷ Davies et al. (2014) op. cit.

Figure 4.10: Fixed assets to sales of UK firms by type of ownership



Source: Davies et al. (2014)

Figure 4.11: R&D intensity of UK firms by type of ownership



Source: BIS Scorecard (2010)

One explanation is that public firms may be more efficient, or more mature facing less investment opportunities. However in a systematic study of US firms that controls for differences in investment opportunities, Asker, Farre-Mensa, and Ljungqvist (2015) compare public firms to otherwise-identical private firms. They find that the former invest significantly less and are less responsive to changes in investment opportunities than comparable private

firms. Moreover, this relationship is stronger in industries in which the stock price responds more to earnings news.²³⁸ Publicly quoted firms do seem to invest less than their private counterparts.

However, the pressure to deliver short-term results is far from absent in private firms. A private equity investor may fire a non-performing manager, or a venture capital investor may not invest in a future financing round if short-term performance is poor. Moreover, there is no reason why some the features of private firms that promote purpose cannot be structured or reproduced in public firms. Notably, it is *ownership concentration*, rather than a firm's public or private status *per se*, that affects these outcomes: as discussed in Section 3, blockholders in public firms may be able to provide the benefits of concentrated ownership. In particular, while there is the well-known adage that 'the market sells first and asks questions later', blockholders – due to their large stakes in a firm – will not automatically sell if a firm delivers low short-term earnings, but instead protect companies from the vagaries of the stock market and allow them to pursue purpose. Indeed, Brockman and Yan (2009)²³⁹ find that stocks with higher block ownership have more informative stock prices, mitigating market myopia.

Moreover, the combination of blockholders and public markets may dominate private ownership because public markets provide substantial other benefits: due to enhanced access to capital, public firms can acquire expertise and innovation by buying up other companies in ways that would be more difficult for private counterparts.²⁴⁰ For many firms this strategy may be the most effective way for them to create long-term value. They are means of pooling information, and there are occasions when market valuations can signal both opportunities and risks of which individual managers are not aware.²⁴¹ Evidence suggests that managers indeed use the stock price in this way, increasing investment when stock prices are high and decreasing it while stock prices are low. But there is another deeper advantage of public markets. They are the only route to any form of popular

²³⁸ Asker, J., Farre-Mensa, J. and Ljungqvist, A. (2015) 'Corporate Investment and Stock Market Listing: A Puzzle?' *Review of Financial Studies* 28, 342–390.

²³⁹ Brockman, P. and Yan, X. (2009) 'Block Ownership and Firm-Specific Information', *Journal of Banking and Finance* 33, 308–16.

²⁴⁰ See also Lerner, J. (2012) 'The Architecture of Innovation: The Economics of Creative Organizations'; Oxford University Press, which argues that the large public company can improve on traditional venture capital by establishing corporate venture capital arms, tasked with investing in young companies pursuing technologies relevant to the parent's business.

²⁴¹ Thus Luo finds that managers are more likely to cancel acquisitions if the market responds negatively to their announcement, particularly in settings where such learning is more likely to be important. Luo, Y. (2005) 'Do Insiders Learn from Outsiders? Evidence from Mergers and Acquisitions', *Journal of Finance* 60, 1951–82. Chen, Goldstein, and Jiang (2007), Bakke and Whited (2010), Foucault and Frésard (2012, 2014), and Edmans, Jayaraman, and Schneemeier (2016) show that investment is more sensitive to the stock price when prices contain more information not previously known to the manager. See Chen, Q., Goldstein, I., Jiang, W. (2007) 'Price Informativeness and Investment Sensitivity to Stock Price', *Review of Financial Studies* 20, 619–50; Bakke, T., Whited, T. (2010) 'Which Firms Follow the Market? An Analysis of Corporate Investment Decisions', *Review of Financial Studies* 23, 1941–80; Edmans, A., Jayaraman, S. and Schneemeier, J. (2016) 'The Source of Information in Prices and Investment-Price Sensitivity', Working Paper. Foucault, T. and Frésard, L. (2012) 'Cross-Listing, Investment Sensitivity to Stock Price, and the Learning Hypothesis', *Review of Financial Studies* 25, 3305–3350. Foucault, T. and Frésard, L. (2014) 'Learning From Peers' Stock Prices and Corporate Investment', *Journal of Financial Economics* 111, 554–577.

capitalism, by which more people can share the fruits of wealth generating enterprise.²⁴²

Do dividends and share buybacks cause underinvestment?

Arguably the most commonly accused contributor towards underinvestment in public firms is the stock market's requirement for dividends and share buybacks. We thus devote a separate sub-section to this topic.

The 'dark side' of payout

A dividend cut leads to a stock price decline of 5-6%²⁴³, thus providing managers with strong incentives to maintain the dividend – even if doing so requires firms to cut investment. Similar to the negative stock price decline upon missing earnings, the negative stock price decline upon reducing the dividend is self-reinforcing.

Relatedly, critics argue that stock buybacks are a way for firms to boost earnings per share, by reducing the number of shares outstanding. This earnings increase is often referred to as 'artificial' or 'manipulation', since it is simply a result of a financial transaction rather than 'true' value creation by increasing productivity. The cash used to fund a stock buyback, the argument goes, could have otherwise been used to fund investment. Moreover, buybacks only reward short-term shareholders, by allowing them an early exit. Thus, stock market investors' demand for a quick buck (in the form of dividends and buybacks) cripples firms and prevents them from investing.

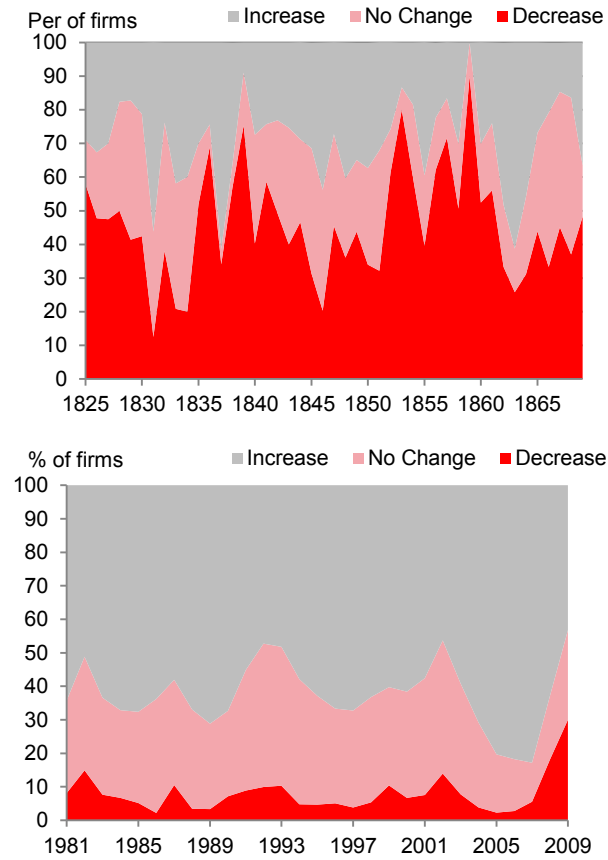
Indeed, some stylised facts would suggest that this is the case. For example, Figure 4.12 below compares dividend payout behaviour among companies in the US during two eras – the mid-19th century when shareholders were less powerful, and the period since 1980 when shareholder primacy emerged.²⁴⁴ The first shows that dividend increases and decreases occurred with similar frequency. In the later period, dividend reductions happened only 8% of the time. Of course, many other factors changed between the mid-19th century and the post-1980 period (such as changes in investment opportunities), and it may be these factors that caused the increase in dividends.

²⁴² McNally, A. (2015) 'Debtator: How Debt Favours the Few and Equity Can Work For All of Us'; Elliot & Thompson.

²⁴³ Jagannathan, M., Stephens, C. and Weisbach, M. (2000) 'Financial Flexibility and the Choice between Dividends and Stock Repurchases', *Journal of Financial Economics* 57, 355–384.

²⁴⁴ Haldane, A. op. cit.

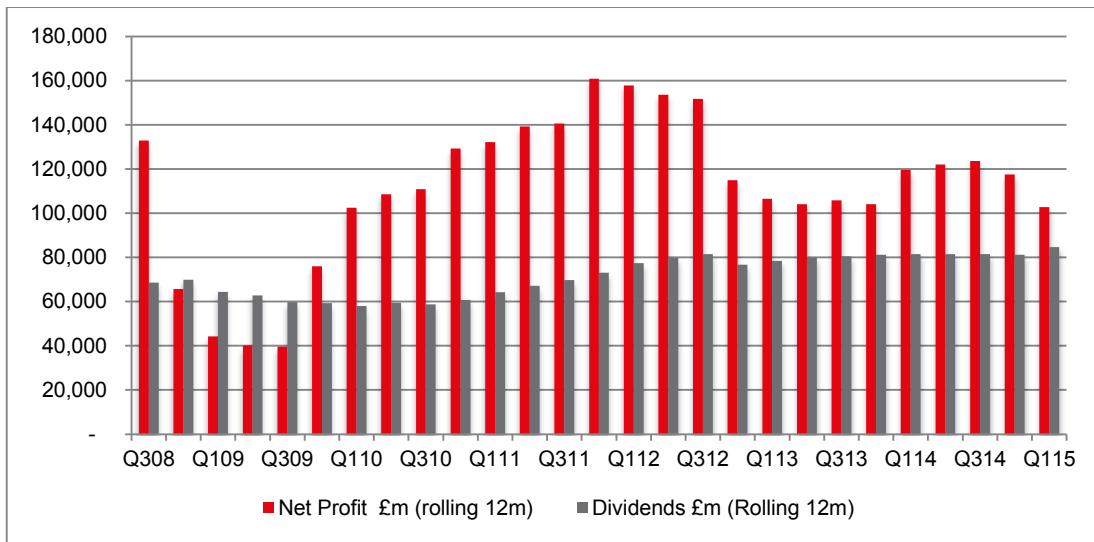
Figure 4.12: Dividend payouts in US firms' pre- and post-shareholder primacy



Source: Haldane (2010), De Angelo, De Angelo and Skinner (2009)

Recent data from the Share Centre (Figure 4.13) showed that in March 2015, dividends in FTSE 350 firms were at their highest level compared to profits. In particular, while profits have fallen since Q3 2012, dividends have been stable, though this fall has largely been concentrated in the commodity-heavy FTSE 100.

Figure 4.13: Dividends and profits for FTSE 350 firms

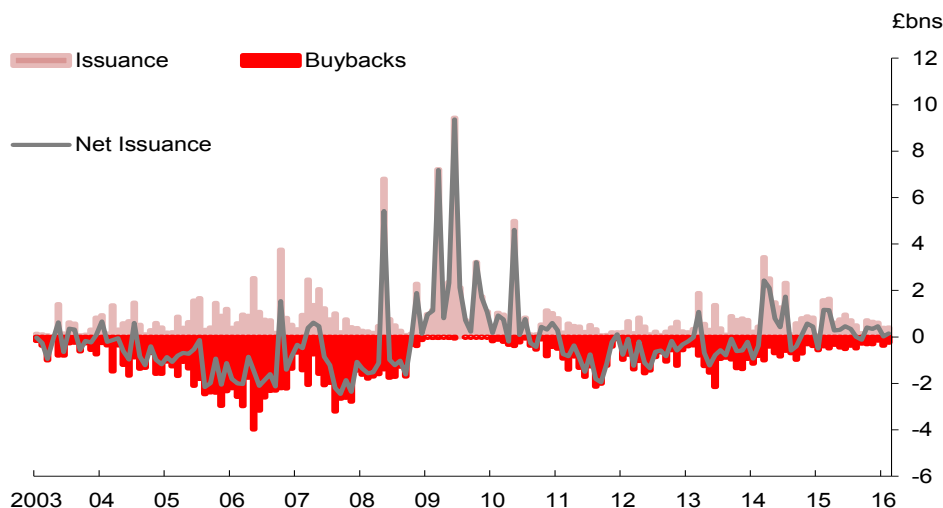


Source: Share Centre (2015)

Turning to share buybacks, in recent years they have consistently outstripped rights issues and public offerings. As a result, the stock market has been a *negative* source of new equity investment, and so the Kay Review dubbed it a means to extract cash from companies rather than a source of capital.²⁴⁵ Figure 4.14 illustrates this and shows that net equity issuance has mostly been negative over the past decade. However, as we will discuss, the aggregate level of net issuance is not an accurate indicator of the stock market’s role in financing investment, as its goal is to re-allocate funds from cash-rich, investment-poor companies to cash-poor, investment-rich ones.

²⁴⁵ See Mayer, C. (1988) ‘New Issues in Corporate Finance’, *European Economic Review* 32, 1167–1189.

Figure 4.14: Share buybacks by UK companies



Source: Bank of England

The 'bright side' of payout

While the argument that the stock market's requirement for dividends and share buybacks causes firms to underinvest is a popular one, it is far from automatic. First, the stock market does not 'require' dividends or share buybacks. Indeed, many public firms do not pay dividends or engage in share buybacks at all. This is particularly the case for start-up firms, who have the growth opportunities. They do not seem to be pressured to forgo growth opportunities to pay dividends. Moreover, low payouts are not confined to start-ups. Microsoft did not start paying dividends until 2003, 28 years into its history. Apple, despite at times being the world's largest firm, currently sits on around \$20bn of cash (plus \$20bn of short-term investments and \$160bn of long-term investments) despite strong pressure by the activist investor Carl Icahn. Indeed, many other shareholders defended Apple's cash position, being willing to forgo immediate payout to support investment. Indeed Dominic Rossi of Fidelity argues there is no necessary trade-off between investment and payouts. Many high-tech companies like Apple can finance both, as higher returns on capital reflecting deeper changes in the economy mean they can invest less capital and still achieve the same profit growth.²⁴⁶

Even if investors require an immediate return (e.g. to finance a liquidity shock), they do not need dividends to provide this return: as pointed out by Miller and Modigliani's (1961) famous theorem, dividends are irrelevant since investors can 'home-make' dividends

²⁴⁶ Rossi, D. (15 July 2015) 'Companies Can Invest and Conduct Buybacks', *Financial Times*, <https://next.ft.com/content/fab09214-2006-11e5-aa5a-398b2169cf79>; see also Koller, T. (2015) 'Are Buybacks Jeopardising Future Growth', <http://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/are-share-buybacks-jeopardizing-future-growth>. The open question is whether profit margins supporting this trend is sustainable.

anyway by selling shares.²⁴⁷ Similarly, shareholders do not demand share buybacks in order to cash in their investment, since they can already cash in by selling their shares on the stock market.

Indeed, the payouts required by equity holders are much more flexible than debtholders, which many private companies are financed by – indeed, leverage rises substantially when a firm is taken private. There is no negative stock market reaction to reducing share repurchases, and while the reaction to cutting dividends is indeed negative, the company still survives – whereas a firm that fails to make a debt payment is in default and may be liquidated. That shareholders seek a return on their investment is not greedy or unwarranted. Virtually *all* stakeholders seek a payoff for contributing to a firm: employees seek wages, suppliers seek payment, and investors seek a return for contributing their capital and bearing risk. While debtholders' demand for a return is 'hard', since they can liquidate a firm that does not pay it, shareholders' demand for a return is 'soft'. Moreover, even investors in private firms also seek a return: for example, private equity investors are concerned with eventual exit and returning cash to their limited partners.

Second, even if we could show that the requirement for payouts caused a firm to reduce investment, this reduction is not necessarily detrimental. Payouts might actually create 'true' value, by preventing bad investments that waste not only cash (a financial resource), but also society's real resources, such as land, labour, and raw materials. Thus, DeAngelo, DeAngelo, and Stulz (2006) find that dividends are significantly positively correlated with the firm's life-cycle stage, i.e. payouts predominantly stem from mature firms with weak growth opportunities.²⁴⁸

Moreover, concerns that payout reduces investment are based on only partial analyses. While investment may fall at the company making the payout, investors can invest the funds elsewhere. As a consequence, studying the *aggregate* level of net equity issuance (as in Figure 4.14 above) is misleading, or at best incomplete. Even if the overall level of net equity issuance is zero, stock markets may still be adding substantial value by re-allocating cash from firms with weak investment opportunities (which pay dividends) to those with strong ones (which issue equity). In addition to this cross-sectional dispersion, the aggregate level of payout is varying over time with macroeconomic conditions (see Figure 4.14 earlier), suggesting that it responds to economy-wide changes in investment opportunities.

The evidence

The conceptual arguments for whether stock markets lead to a requirement for payout, whether a requirement for payout leads to a reduction in investment, and whether a reduction in investment is socially undesirable are thus far from clear. We now turn to the evidence, and again start with surveys.

²⁴⁷ Miller, M., and Modigliani, F. (1961) 'Dividend Policy, Growth, and the Valuation of Shares', *Journal of Business* 34, 411–433.

²⁴⁸ DeAngelo, H., DeAngelo, L. and Stulz, R. (2006) 'Dividend policy and the earned/contributed capital mix: a test of the life-cycle theory', *Journal of Financial Economics* 81, 227–254.

The most-cited survey of the effect of payout policy on investment is by Brav, Graham, Harvey, and Michaely (2005).²⁴⁹ They surveyed 384 financial executives and concluded that “maintaining the dividend level is a priority on par with investment decisions. Managers express a strong desire to avoid dividend cuts, except in extraordinary circumstances. However, beyond maintaining the level of dividends per share, payout policy is a second-order concern; that is, increases in dividends are considered only after investment and liquidity needs are met.” Thus, the findings are nuanced. On the one hand, firms that are already paying out dividends feel strong pressure to maintain the level of the dividend, and may cut investment to do so. However, it is not the case that firms view *increasing* the dividend as a greater priority than investment. Firms that are not already paying dividends do not seem to feel pressure to start doing so, consistent with Microsoft being able to pay zero dividends for decades.

In sum, there is path-dependence in the level of dividends. While firms feel little pressure to increase the dividend, firms already paying dividends face significant pressure to retain them. Indeed, the authors find that “many of those firms that pay dividends wish they did not, saying that if they could start all over again, they would not pay as much in dividends as they currently do.” As a consequence, the stock market should allow firms to ‘reset’ their level of dividend if doing so would strengthen their balance sheet or facilitate investment, rather than automatically punishing a firm for a dividend cut. There is some evidence that the market has been moving in this direction: for example, shares of Rolls-Royce rose by 13% following the announcement of a 50% dividend cut in February 2016, though investors were also relieved that the company had not issued another profit warning, with some fearing the worst after enduring five profit warnings in the previous two years.

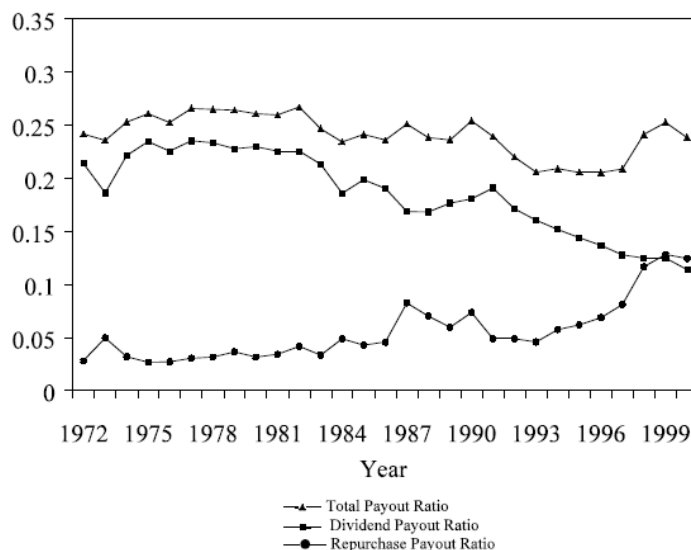
In contrast, repurchases appear to be fully flexible and there is not even the requirement to maintain prior levels of repurchases. Brav et al. also find that “in contrast to decisions about preserving the level of the dividend, managers make repurchase decisions after investment decisions. ... Companies are likely to repurchase when good investments are hard to find.”

The results also suggest that repurchases are a more flexible way of returning surplus cash than dividends – firms can return repurchases one year, and not be constrained from investing in future years. This may explain why, since the 1980s, firms have substituted away from dividends toward repurchases (while keeping total payout constant), as shown in Figure 4.15 below.²⁵⁰ Thus, the common criticisms of repurchases are not necessarily warranted. If repurchases are motivated by poor investment opportunities, then instead reinvesting the cash would destroy value, and instead paying it out as dividends would constrain future investment when growth opportunities subsequently recover.

²⁴⁹ Brav, A., Graham, J., Harvey, C. and Michaely, R. (2005) ‘Payout Policy in the 21st Century’, *Journal of Financial Economics* 77, 483–527.

²⁵⁰ Grullon, G. and Michaely, R. (2002) ‘Dividends, Share Repurchases, and the Substitution Hypothesis’, *Journal of Finance* 57, 1649–1684.

Figure 4.15: Substitution from dividends to repurchases



Source: Grullon and Michaely (2002)

Moving away from survey evidence, we now look at the long-run returns to payout, to study whether it is indeed a way to pump up the short-term stock price at the expense of long-run value. Starting with dividends, Grullon, Michaely, and Swaminathan (2002) show that increases in dividends are associated with a future decline in capital expenditure and profitability. This result has two contrasting interpretations – the increase in dividends is an optimal response to firm maturity and falling investment opportunities, or the increase in dividends caused the reduction in investment. Supporting the former interpretation, firms that increased dividends and also experienced the largest decline in systematic risk (a sign of firm maturity) enjoyed the largest increase in stock prices over the following three years.²⁵¹ Turning to repurchases, Ikenberry, Lakonishok, and Vermaelen (1995) find the announcement of share repurchases leads to an abnormal four-year return of 12.1%, inconsistent with the hypothesis that repurchases are at the expense of long-run value. Moreover, the return is 45.3% to firms with low market-to-book ratios, which may be a sign of low growth opportunities (or, alternatively, undervaluation).

However, the evidence that repurchases *in general* do not appear to be myopic does not rule out the possibility that *some* repurchases may be. Almeida, Fos, and Kronlund (2016) focus on repurchases that are motivated by the need to beat the earnings target (rather than, say, to pay out surplus cash).²⁵² They compare repurchasing firms that would have just missed the earnings target without the repurchase, to those that would have just beaten it. Since it is essentially random whether a firm is just above or just below the earnings target, their ‘regression discontinuity’ design allows them to identify causal effects. They find that EPS-

²⁵¹ Grullon, G., Michaely, R. and Swaminathan, B. (2002) ‘Are Dividend Changes a Sign of Firm Maturity?’ *Journal of Business* 75, 387–424.

²⁵² Almeida, H., Fos, V. and Kronlund, M. (2016) ‘The Real Effects of Share Repurchases’, *Journal of Financial Economics* 119, 168–185.

motivated repurchases are associated with reductions in employment and investment. Taken together with the positive long-run returns to repurchases in general, these results suggest that the driver of short-termism is a focus on earnings targets (consistent with elsewhere in this chapter), rather than repurchases *per se*.

Turning to the link between dividends and investment, Smirlock and Marshall (1983) found no relationship and concluded that these decisions are undertaken independently.²⁵³ Even if a negative correlation were shown, it would not be clear whether payouts cause declines in investment, or whether instead a decline in investment opportunities optimally leads to firms increasing their payout ratios. In sum the key to investment is less firms' choices about how they return money to shareholders as either dividends or share buybacks (with share buybacks offering some flexibility that dividends do not), but rather their capacity to sustain a purposeful, value-generating strategy over time and the degree to which they are pulled away from such strategies by a stock-market that misvalues their future earnings.

Conclusion

Intangible assets have become increasingly important over recent years, particularly in the UK, and will continue to do so in future given structural trends towards services and high-end manufacturing. They are a key driver of labour productivity, particularly given spill-over effects and complementarities with tangible capital. The increasing importance of intangibles poses a particular challenge for investment, since the stock market takes many years to recognise the full value of intangible assets. Thus, managers pressured to maximise short-term earnings, due to compensation being tied to short-term earnings (or the short-term share price), the requirement to disclose short-term earnings, or dispersed investors evaluating a firm primarily on the basis of short-term earnings, may underinvest.

However, these pressures are far from absent in private firms, as private investors also demand returns to their investment. Even if certain features of private firms do allow them to better support intangible investment, they can be partially replicated in public firms through less frequent reporting, long-term incentive contracts, and block shareholders. This may allow any costs of ownership in public markets to be mitigated while still reaping the benefits – in particular, far from being a potential cause of myopia, the existence of a share price in public firms can support investment by providing useful signals to management of a firm's investment opportunities.

While the 'requirement' to pay dividends and buy back shares in public firms is often cited as a cause of myopia, both the conceptual arguments and empirical evidence are mixed. Both dividends and repurchases are ways of reallocating surplus cash to other sectors of the economy that have superior investment opportunities. The most convincing evidence

²⁵³ Smirlock, M., and Marshall, W. (1983) 'An Examination of the Empirical Relationship between the Dividend and Investment Decisions: A Note', *Journal of Finance* 38, 1659–1667.

supporting the short-termism view is managers' pressure to maintain an existing level of dividend, or to engage in a stock buyback to meet an earnings target. The more a company can express purpose, supported by block shareholders and appropriate managerial incentives, the more likely it will be to resist such short-termist pressures. The task is to create an institutional framework where it is more likely to happen than at present. In Chapter 5 we float a variety of policy options that might deliver more purposed companies.

5. What is to be done?

If Britain's business sector could better express purpose, the evidence assembled in this report shows the impact would be transformative. The open question is how. We have gathered together a range of policy options. There are deliberately defined as policy options and not recommendations since it is not appropriate to be prescriptive at this early stage. They are set out in the table below, building on the analysis of the previous four chapters, which would push the biases in the corporate, ownership, asset management and capital market ecosystem decisively towards purposefulness. Some are more radical departures than others; some can be done by companies and/or the investment community alone; others require regulatory or government initiative. All are feasible.

The proposals are clustered under five main headings, setting out the case for the idea, the challenges and opportunities along with potential objections and obstacles. Firstly there is a range of options under the rubric of *business implementation and remuneration*. Essentially companies are invited to make purpose more salient in their corporate thinking, company statements and business practice and designing remuneration structures. Executive incentives should also be re-organised to incentivize managers to behave more as engaged purposeful owners than transient investors: in particular vesting periods for equity should be much longer term.

Secondly we cluster a range of devices that could push *corporate governance* in the direction of purpose. There is a discussion of the case for *modified* or *hybrid* staggered boards and dual shares raised in Chapter 2, restrictions on the rights of short-term shareholders during takeover bids along with strengthening the voice and power of stakeholder groups – whether through reform of Section 172 of the 2006 Companies Act or even the establishment of new stakeholder panels. Benefit Corporations and their various offshoots have pioneered a redefinition of fiduciary obligations, which could also be borrowed and extended into British corporate law.

Next we consider how better to improve the *blockholding, monitoring, and engagement*, perhaps introducing guidelines for better interaction on purpose. Here more systematic and sophisticated accounting for intangible assets will help investors get a better handle on corporate strategies in an area where returns are both long term and hard to evaluate. These ideas are related to the arguments made in Chapters 3 and 4 about the crucial importance of independent, arms-length institutional block-shareholders who can act as custodians of purpose. We found that it is blockholders who tend to be the common characteristic of high performing public and private firms. Loyalty shares, improved information disclosure and safe-harbours for large investors who in exchange for supporting purpose win access to privileged inside information are all potential ways forward – but all with downsides.

Next we turn to *strengthening the capabilities of asset owners*. There are too many small underpowered and under-resourced pension funds: consolidation would greatly improve the sector's capabilities and capacity to get behind purposed companies. Pension fund trusteeship could be radically professionalised and certain investments in an ISA wrapper should have a positive duty to promote corporate stewardship in return for the tax advantages they enjoy. There could also be a strengthening of the stewardship code along with tax incentives to encourage asset managers to sign up.

Lastly we discuss how to reverse the *decline in British equity ownership*. One option would be to create a British sovereign wealth fund investing in purposed public and private companies, while equalising the tax treatment of debt and equity as the Mirrlees Review recommended would promote equity issuance. Employee stock ownership schemes could be enlarged by extending membership to a wider range of stakeholders who support the company purpose. Customer stock ownership plans (CuSOPs) would supplement ESOPs.

Action is required in all five clusters in order to create the cumulative, strong self-reinforcing dynamic to generate purpose, and some measures will undoubtedly involve legislation, tax changes and regulatory reform. We rule nothing in or out at this stage, so welcome encourage comment, criticism and suggestions from as wide a body of interests and opinion over the next two months as possible. The evidence case for change is indisputable, but reform will require not only conviction that Britain cannot continue as it has – but the creation of as wide support as possible to support any proposed reform. We hope our consultation exercise will be a catalyst for winning such support and wider policy learning.

Policy options and background

Policy Option	Justification	Issues & Questions
Business implementation and Remuneration		
<p>1. Require companies to incorporate around purpose. The process of incorporation is generally called 'formation' in the UK and there is no requirement to be explicit around the proposed business purpose.</p>	<p>As evidenced in Chapter 1 the success of a business depends on its relationship with the outside world – potential customers, staff and suppliers and shareholders, regulators, activists and legislators. Companies should therefore make it clear when they incorporate how fulfilling their purpose benefits society.</p>	<p>What is to stop a company merely 'window dressing' with their purpose? How much flexibility would companies have to change purpose in changing circumstances?</p> <p>What, if any, duties flow from incorporating around purpose? What requirements would follow for reporting on business purpose post-incorporation?</p> <p>Should the Bank of England be required to interpret practices for the Banks and Insurance Companies?</p>
<p>2. Require companies, voluntarily or by law to produce purpose statements and annual performance reports (including materiality maps) that can be assessed against comprehensive, independent and transparent third party standards.</p>	<p>This would create an externally verifiable template(s) for every company to operate with a meaningful purpose statement and demonstrate how they achieve long-term value creation. This would complement other recommendations such as incorporation, broadening of directors' fiduciary duties and accounting standards to strengthen the reporting and measurement of intangibles.</p>	<p>To what extent would it ensure companies behave in accordance with their stated 'purpose' and will consumers and investors act on the disclosure of this information?</p> <p>What should the third-party standard look like and who should be tasked to define it.</p> <p>What is the most effective way of determining and disseminating best practice among standards providers?</p> <p>To what extent should government play a role in standardisation or should decisions be left to the market.</p> <p>Are there alternatives to this – e.g. having firms employ 'purpose' auditors – external professionals of some kind to review information contained in annual reports are correct.</p>
<p>3. Accounting standards to be</p>	<p>Most of the discussion to date has been about disclosure in relation to</p>	<p>Are accounts the appropriate form in which to provide valuations of imprecisely measured</p>

<p>revised to reflect the growing significance of intangible assets – possibly around a common template. Companies to provide clearer guidance on the degree to which investments in both tangible and intangible assets are delivering against their corporate purpose, value generation prospects and risks.</p>	<p>ESG (as set out for example by the UN Principles for Responsible Investment) and adopted by several stock exchanges around the world, such as the Hong Kong Stock Exchange. However aligning disclosure with purpose goes well beyond this. It also refers to the relation of financial to other measures of performance, for example human, natural and social as well as financial capital. It also bears on the horizon of investors and the information that is required to promote a focus on long term investment, as discussed in the recent Investment Association report. It is also consistent with evidence that companies can to some extent select the types of shareholders they want through effective investor communication</p> <p>The task of accurately valuing intangibles would be assisted by the development of market-places to allow IP to be traded (the purpose of the Big Innovation Centre’s Intellectual Property Exchange). This would replace the subjective judgements. Of directors and auditors with an objective valuation.</p> <p>Prescriptive regulation may not be appropriate in this area given the diverse forms of disclosure that are relevant to different corporate purposes. As the case of Unilever illustrates, it may be a matter of companies emphasising relevant measures of performance and investors seeking disclosure of them. The Investment Association suggests that institutions may be able to do a great deal through informal guidance.</p>	<p>intangibles, human, natural and social capitals?</p> <p>What explains the progress (or lack of it) of related accounting and reporting initiatives (e.g. Integrated Reporting)?</p> <p>Will earnings guidance be sufficient to bring about fundamental changes in investor and corporate behaviour?</p> <p>Should guidance move from providing point estimates to communicating uncertainty around forecasts?</p> <p>Should companies receive more information from investors about their reasons for changing equity holdings – tantamount to an exit interview – so as to reduce any short-term reactions by company management?</p>
<p>4. Ask business schools and providers to develop a major 'purpose' component into their business education curricula (MBA, CFA etc.). To include the development of product sets that enable firms to move from</p>	<p>This would complement other recommendations to stimulate and entrench culture change. Value creation can be damaged if those providing governance behave in a way that is in conflict with purpose.</p>	<p>How can the provider market be stimulated to develop new product sets that are most important from a value creation standpoint?</p> <p>Is there evidence from similar initiatives in the past that these values have been internalised?</p> <p>Is there value in requiring candidates for appointment to board, trustee and investment</p>

<p>abstractions and focus on specific purpose activities that are most important from a value creation standpoint.</p>		<p>committees to be 'purposeful financial market certified'?</p>
<p>5. Develop remuneration principles, guidelines and practices for both firms and investment houses to reinforce the delivery of purpose and the creation of long-term value creation. The aim is encourage managers to behave more as purposed engaged owners than short-term investors.</p>	<p>A principles-based approach with clear practical guidelines and evidence of good practice is the best way of giving remuneration committees and shareholders confidence that the change required has serious intent. It will give remuneration committees freedom to innovate purposeful pay programmes that deviate from the norm, while giving investors confidence that pay will remain aligned to long-term value.</p> <p>Incentives should be focused on long-dated equity rather than performance-based-vesting.</p> <p>Vesting horizons should be to the long term – ideally deferral and holding periods should be extended to 5 to 7 years in combination and in some industries longer timeframes may be required. In addition, CEOs should be required to hold shares for at least two years beyond their departure. This has the additional benefit of ensuring that executives will invest in succession planning and choose successors objectively. This approach is likely to lead to executives having shareholdings above current norms.</p> <p>Guidance should be given that executives be paid partially with debt to deter them from taking excessive risk. Final salary pensions, particularly if unfunded, provided such debt payments in the past. New long-dated debt vehicles are now required, and should ideally extend beyond the end of the CEO's tenure</p> <p>Any bonuses should be modest compared with pay components of long-term equity, and should be based on a balanced range of measures emphasising long-term value and purpose.</p> <p>Remuneration reports should clearly show how incentives are aligned to purpose and long-term value creation. Transparency rules should</p>	<p>How long should the vesting period be? Can it be calibrated for sector and firm differences?</p> <p>Longer vesting and holding periods may result in executives discounting the value of awards and so demanding higher remuneration to compensate. Would this be politically acceptable?</p> <p>How would the guidelines be enforced and would they have to be internationally coordinated?</p> <p>Are guidelines sufficient to address any externalities arising from competition?</p> <p>Regardless of how compensation is designed, executives may continue to take myopic action because their jobs depend on it. How can these pressures be mitigated?</p> <p>What is the role of nonfinancial performance measures in executive compensation?</p>

	<p>be strengthened and remuneration committees expected to reduce the earnings of executives via discretion or through underpinning conditions where there are quality of earnings issues. To enable this, definitions for incentive metrics should be disclosed and remuneration committees should fully disclose any adjustments made.</p>	
<p>Corporate Governance and Commitment Devices</p>		
<p>6. Remove the regulatory bias against staggered boards, which can be an important way of ensuring that purpose is sustained over time.</p>	<p>Evidence suggests that a modified form of staggered boards can serve as a commitment device. These devices may be a commitment device for companies to bond themselves to their counterparties by decreasing the probability that current management will be replaced and company policy altered. There appears to be a particular association of this with the relationships of companies with other parties and the need to provide commitment to them.</p> <p>It is also argued that staggered boards promote continuity and incentives to engage in long-term strategies that are not vulnerable to short-termism.</p> <p>On its own, this measure can be quite powerful. However, its potential importance is as part of a package of measures that moves away from prescriptive regulation based on a particular model of corporate governance to regulation that enables companies to adopt structures that are suited to the delivery of their purpose.</p>	<p>The force of staggered board mechanisms is diminished in the UK by a mandatory rule that shareholders may remove directors at any time by ordinary resolution. A shareholders meeting to vote on such a resolution can be requisitioned by 10% of the company's voting shares. Furthermore, in the US, staggered boards are controversial in some quarters and may have led to entrenchment, reducing value.</p> <p>Staggered boards play out differently outside and inside of takeover settings (the latter is often accompanied by a poison pill): what, if any implications does this difference have for the use and effectiveness of staggered boards?</p> <p>Policy discussions and empirical evaluations have centred on the choice between a traditionally staggered board and a board at which every director stands for election at every year. What, if any scope is there for more intermediate or hybrid forms – i.e. a board that begins as staggered but automatically loses this status where it underperforms its peer group for a certain period of time?</p> <p>In what other ways, might a staggered board be modified to balance costs and benefits?</p>
<p>7. Remove the regulatory bias against dual class shares (i.e. restrictions on premium listings) in order to permit founders and others to protect purpose.</p>	<p>The argument for dual class shares is that they allow entrepreneurs and founders to protect and promote the vision of a company after it has gone public. Dual class shares may mitigate underinvestment resulting from problems of contracting over firms' investment. The evidence from the UK is that equity ownership has become highly dispersed because of an inability to fund growth through equity issuance without diluting the control of families and founders. Many young companies consequently find it difficult to scale-up without</p>	<p>Would moving from one share-one vote lead to abuse and entrenchment?</p> <p>Has the LSE taken sufficient account of the interests of users of finance (companies) as well as the providers (investors) in its listing rule, which prohibit dual shares?</p> <p>Other major stock exchanges, such as the NYSE, function successfully without such restrictions. Why should they be a more serious problem in the UK than the US?</p>

	losing control.	What principles, if any, might inform the design of dual class shares to address the potential for abuse and unintended consequences e.g. sunset clauses, vote caps, minimum equity thresholds held by insiders, open eligibility criteria, basic voting rights for common shares and other governance requirements?
8. Review s.172 of the Companies Act 2006 to broaden the fiduciary responsibilities of directors to include the expression of purpose.	<p>Under s.172 (1) directors of a company are required to act in ways that promote the success of the company for the benefit of its members as a whole (i.e. the shareholders) and in doing so have regard to a broader set of stakeholders (employees, suppliers, customers, community and environment, the company's reputation and long-term condition, as well as to act fairly between members of the company). As argued in Chapter 1, in reality directors practically have to take into account these heterogeneous interests. This formalises existing best practice.</p> <p>However the 'have regard' provision only weakly ensure the interests of the broader set of stakeholders are taken into account.</p> <p>First, the interests of shareholders have precedence (broader stakeholders' interests are taken into account only when they are in conflict with shareholders' interests).</p> <p>Secondly, there is no incentive-compatible mechanism for disciplining directors that fail to 'have regard' – only shareholders have the right to enforce a breach of duty.</p> <p>Thirdly, the provision seems to have had little effect in practice – there has only been one case where the broader scope of s.172 has been considered by a court.</p>	<p>The scant use of existing mechanisms (both in the UK and abroad e.g. Canada) suggests the impact of modifying company law along these lines may not be very great. Even shareholders have struggled to bring derivative actions against directors given the extensive safeguards in place to weed out inadequate claims.</p> <p>If broader stakeholder interests were put on a par with shareholders', directors would have weight their different, potentially conflicting interests more transparently. How could that weighting of interests be monitored or enforced?</p> <p>Will courts feel they have the expertise to judge in such cases (i.e. business judgement rule)?</p> <p>In what other ways could s.172 be designed? Or, might it be more sensible to target policies at different kinds of stakeholders – e.g. potential conflicts between short-term and long-term interests of shareholders through company law (or, say, encouraging blockholders) or the interests of employees, customers, environment through specific legislation?</p>
9. Introduce Public Benefit Corporation legislation, whether along the lines of the Blab model or more tailored approaches of individual US states (e.g. Delaware, the FPC	This legislation provides for the creation of a company with an explicit declared public or specific purpose within its article of incorporation. This implies that its directors have a fiduciary duty to ensure the company follows that purpose. Together with should be combined with disclosure requirements (i.e. record of performance against a	<p>Holding directors accountable treads a fine line between being too weak and too strong; standing to bring a benefit enforcement proceeding is largely limited to shareholders. Would they have an incentive to?</p> <p>In part, it relies on courts being able/willing to assess whether a company has fulfilled its</p>

<p>in California).</p>	<p>public or specific purpose in an annual report).</p> <p>It is an approach to allowing wider stakeholder interests to be taken into account by companies in a more tailored fashion than under a change in fiduciary duties in company law while representing a stronger form of option 1.</p> <p>The scope to set up as a benefit corporation has been introduced in 30 states in the US, with evidence of state-level flexibility and experimentation.</p>	<p>social purpose versus maximising shareholder value (see above).</p> <p>What obstacles exist to adopting mission-aligned corporate structures suitable for the size and scope of large listed companies (to date, most benefit corporations have been start-ups and no listed firm has converted to a public benefit corporation)?</p> <p>If incentives to set up as benefit corporations are introduced (e.g. tax incentives), who would check to make sure the 'social purposes' are meaningful/credible (not mere corporate cant)?</p>
<p>10. Restrict the role of short-term shareholders during takeover bids – whether by granting existing shareholders' additional votes or limiting voting rights acquired during the offer period.</p>	<p>Post Cadbury, the Takeover Panel has taken measures to protect long-term interests of investors and stakeholders. Put-up-or-shut-up requirements, greater recognition of employee interests, improved transparency of bidders' plans and increased clarity over post-offer commitments are steps in this direction. For some commentators, the collapse of Pfizer's bid for AstraZeneca is evidence that the new rules are serving their intended purpose.</p> <p>Despite these changes, the takeover regime remains a halfway house, unlikely to deter serious bidders that want to build large positions in the target stock. Recall that after Kraft had announced its Cadbury bid, 31% of the Cadbury register had become owned by short-term investors in the first 44 days. Such merger arbitrage activity still allows shareholders to sell down some of their holdings to lock in the higher post approach share price as an insurance against the bid ultimately failing – in the process increasing the pressure that merger arbitrageur specialists can put on boards to accept a bid.</p> <p>The idea of limiting the rights of short-term shareholders during takeover bids has parallels elsewhere. One example is the French <i>Loi Florange</i> which doubles votes after two years, though its rationale and remit go beyond merger arbitrage. The French approach, however, is less likely to be effective than a policy to restrict voting rights as it amounts to new shareholders having half voting rights rather than</p>	<p>What are the costs and benefits of merger arbitrage activity? How has its incidence and nature changed over time?</p> <p>Would it be preferable to restrict votes or grant existing shareholders additional rights? How long would measures be in force? If shareholders were granted additional rights, what would the voting structure look like (i.e. double voting rights)?</p> <p>Given the intermediation of shareholding structures, can eligible shares be precisely and rapidly identified? Would additional mechanisms be necessary to prevent votes being traded separately from their underlying economic interest?</p> <p>Can steps be taken to mitigate unintended consequences? One concern is that existing long-term shareholders or white knights who wanted to acquire more shares in order to reject a takeover would be discriminated against by these rules. Another issue is that rules would reduce the demand for a company's shares which would simply increase the chances of a successful takeover at a lower price?</p> <p>Would this policy adequately address the role of short-term investors that take a speculative position in a company <i>before</i> the announcement of an offer period?</p> <p>What other alternative remedies might be considered i.e. raising the offer acceptance level</p>

	<p>none. It also risks entrenching established shareholders (including in France the state) to the detriment of newer shareholders, notwithstanding its value as a reward for longer-term shareholding.</p> <p>A policy to grant existing shareholders additional voting rights on the announcement of an offer period, by contrast, would address the permanence issue of the <i>Loi Florange</i> yet would be less draconian than stripping all votes from shareholdings acquired during the offer period.</p>	<p>condition from 50% to 60%?</p>
<p>11. To resolve stakeholder disputes over purpose, specialist panels with representatives from finance, law, management, consumer associations, and other relevant disciplines should be created. This would be especially important if stakeholders are to be legally empowered (see options 7 and 8).</p>	<p>Conflicts between different stakeholders will need to be resolved if wider stakeholder interests are to be taken into account. The panels would have clear triggers for their intervention, and be part or even fully publicly funded (like Acas).</p> <p>Panels of relevant specialists should be created to seek resolution in stakeholder disputes rather than cases being taken to court. Courts are reluctant to go beyond narrow rulings because of lack of expertise.</p>	<p>What would be the trigger for calling in the panels? Would the power to call in the panels lie solely with the directors? If not, how could disparate groups of stakeholders (e.g. customers) coordinate to call in a panel?</p> <p>Who would pay for the panels? Would they need to be public bodies?</p>
<p>Blockholding, Monitoring, and Engagement</p>		
<p>12. Introduce loyalty shares that offer financial incentives rather than additional voting rights to shareholders who hold their stock for a particular period.</p>	<p>One argument for loyalty shares is that it rewards costly monitoring by blockholders. The benefits of blockholding are spread across the entire shareholder base; but the blockholder shoulders most of the costs of these activities – ones that often entail substantial involvement with the company over a number of years. By enabling shareholders to purchase additional stock at a fixed price after a period of time, of, for example, three years, loyalty shares, in turn, enable the formation of larger blocks.</p>	<p>Aside from the potential for entrenchment, what is the relationship between prospective shareholding in the future and the past? Shareholders who have held in the past may be more inclined to sell in the future. How can allocation of cash-flow or control rights be linked to prospective future investments rather than past holding periods?</p> <p>How are the risks of passive long-term holdings to be avoided?</p> <p>Where financial incentives are introduced, should these take the form of special dividends or warrants? What are the strengths and weaknesses of each? Which is likely to perform in</p>

	<p>Providing financial incentives rather than additional voting rights are less likely to result in entrenchment and reduce liquidity. There is also little evidence that granting more votes strengthens shareholder engagement.</p> <p>Several countries (e.g. France and Italy) and some companies (e.g. Toyota) have introduced loyalty share provisions.</p>	<p>particular market conditions e.g. periods of volatility – when a committed shareholder base may be particularly important to the firm?</p>
<p>13. Incentivise block-holders by creating ‘safe-harbour’ provisions.</p>	<p>At one level, there is an incentive for companies and executive teams to have a continuous dialogue with their largest shareholders over the strategic direction of the company.</p> <p>In contrast, institutional shareholders have little incentive to build large positions in companies. Liquidity in the secondary cash equity market is limited, and there are additional transaction costs to institutional shareholders building significant stakes in companies, which can be material. This is especially true for institutional investors managing portfolios with daily liquidity requirements.</p> <p>At the same time, the UK regulatory agenda has championed the view that retail and private investors should not be disadvantaged by an asymmetric dissemination of information that would favour institutions. Consequently, institutional shareholders with large stakes in a company are restricted to the same level of disclosure as a retail investor owning a single share.</p> <p>As a consequence together, the combination of high liquidity costs and the regulatory approach to disclosure, discourage institutional shareholders from building strategic blockholder stakes in publicly quoted companies. The current regulatory framework should be amended to create ‘safe harbours’ where companies can discuss price sensitive information with their largest shareholders.</p> <p>Blockholders who stayed invested in companies would play a useful signalling role to other investors.</p>	<p>To what extent would this privilege large institutional shareholders over other actors who will have access to ‘inside’ information but not face civil or criminal penalties?</p> <p>What would be necessary to mitigate these risks? For instance, blockholders might commit to holding their shares for extended periods of time, backing company purpose statements and submitting themselves to the scrutiny of the same independent panel established to ensure the observance of fiduciary obligations defined in terms of purpose.</p> <p>Would an additional provision that blockholders could not act on such information within certain proscribed time periods make sense?</p>

<p>14. Require fund managers to disclose measures that signal their degree of conviction and engagement with companies.</p>	<p>Sustainable value creation relies on shareholders to price and allocate capital among different business opportunities. It is supported when they bring new and unique information through their analysis and monitoring of corporate performance. Competition based on relative performance, reinforced by the rise of passive investing, may have had ambiguous consequences for price discovery and accountability of asset managers.</p> <p>While information on monitoring activities is provided by fund factsheets and investment research providers such as Morningstar, it is often scattered, rationalised in very narrow terms (e.g. fees/costs) and not always easy to understand.</p> <p>There has been movement in this direction, with the popularisation of measures like active share, understood as a fund managers deviation from the benchmark index (or 'conviction') which some researchers have linked to outperformance, albeit this link is not uncontroversial.</p> <p>Other measures might include average size of holdings and number of stocks, level of research required to trade, the fund's approach to intangibles, the number of professionals involved in investment decisions and company engagements.</p> <p>Funds might also be prevented from reporting only short-term performance – e.g. a fund with minimum performance horizon of 3 years would not be allowed to report 1 and 2 year performance without also reporting the 3 years. There could also be the encouragement/regulation to stimulate formation of non-for-profit mutuals aggregating and exercising proxy votes.</p>	<p>Would a focus on hard information come at the expense of equally valuable soft information – and how might this be addressed?</p> <p>Rather than relying on a specific metric like active share, for instance, might a duty requiring closet indexers (however calculated) to explain their stock selection/investment process be preferable?</p> <p>Which other measures might have valuable informational content?</p>
<p>15. Develop a Stewardship Standard / kitemark to enable differentiation of asset managers by investors and companies.</p>	<p>Being a PRI or Stewardship Code signatory conveys little meaningful information about the stewardship approach of different fund managers.</p> <p>A minimum standard / kitemark and benchmark for best practice would improve accountability and good practice among fund</p>	<p>A standard/kitemark may only give assurance over the processes a fund manager has in place. To what extent would it shine light on quality of outcomes?</p> <p>How far would a standard/kite mark influence savers' behaviours? Significant survey evidence suggests savers would prefer their savings managed in line with stewardship and long-term value creation, though actual behaviour from the marketplace is mixed. What accounts for this</p>

	managers. A standard would allow asset owners, retail investors and indeed companies to easily assess which fund managers are committed to exercising their stewardship commitments in a meaningful fashion. It could be modelled on the International Standards on health and safety and environmental management.	gap between intentions and actions and how might it be reduced?
Strengthening the capabilities of asset owners		
16. Accelerate the merger of subscale pension schemes	<p>The nature of small-scale pension funds in the UK (there are ~45,000 occupational pension schemes in the UK, 90% of which have fewer than 100 members) results in increased principal-agent issues; difficulties for individual schemes to access certain asset classes/strategies, and a lack of expertise in governance arrangements. In turn sponsoring companies:</p> <ul style="list-style-type: none"> • Divert funds from long-term productive use to manage shorter-term pension deficits; • Diverting potentially distributable profits away from providers of capital • Diverting potential contributions available to be provided to current employees (and thus invested on their behalf) to fund benefits to retired employees <p>The UK should follow Australia's example and introduce a positive duty on trustees to consider annually whether the fund has sufficient scale to deliver value for money as measured by long-term net returns. Such explanations could be reported to and considered by the Pensions Regulator. In addition, TPR could be provided with the tools to force mergers of schemes where performance is poor and/or recovery plans are not likely to be met.</p>	<p>What steps would need to be taken to merge funds with different liability profiles and funding arrangements?</p> <p>How would this interact with other developments i.e. the shift to global passive tracker funds?</p> <p>Is the DC market a better candidate for consolidation where scale may be easier to achieve?</p> <p>How can the independence of a resultant 'super fund' be maintained (i.e. commercial Master Trusts have scale but necessarily the same fiduciary duties towards beneficiaries)?</p>
17. Clarify the requirement for pension fund trustees to take advice	Section 36(3) of The Pensions Act sets out the requirement for trustees to obtain and consider proper advice before investing in any manner. 'Proper advice' means from an appropriately authorised adviser. This is generally interpreted to mean that funds must obtain	How would policy address the current grey area between advice over asset allocation and investment instructions, which would necessitate FCA authorisation?

	<p>the services of investment consultants for whom commercial realities incentivise churning of managers and the provision of often generic strategic advice. This interpretation thus means funds incur not insubstantial costs and potentially receive advice which is not value enhancing from agents whom are not the subject of much oversight by funds and not accountable to beneficiaries or regulators.</p> <p>Clarifying the requirement to take advice may be met by the establishment of a suitably qualified internal investment executive may result in overall cost savings through better governance and better oversight of agent relationships including better alignment in mandate terms, less reliance on benchmark comparisons and reduced churning of managers.</p>	
<p>18. Impose a positive duty on providers of tax advantaged savings vehicles to 'do' stewardship (or to outsource to an overlay provider)</p>	<p>In a bid to encourage a greater savings culture individuals can now invest up to £15,240 annually in a stocks and shares ISA. Investments in an ISA wrapper enjoy significant tax advantages; however, there is no obligation on those managing those investments to vote their shares or be engaged with the companies in which they invest. Similarly, a focus on fees in DC pension schemes is pushing providers to offer low-cost passive funds. Passive investing is not necessarily at odds with good stewardship but there may be limits to what it can achieve.</p> <p>As a quid pro quo of attracting savings through the tax-advantaged wrapper (certain) firms should be expected to do engagement and voting or to outsource such responsibility to an independent provider of these services – or not-for profit mutual could be established to fulfil this function (see above).</p>	<p>Who would be subject to this duty given many firms do not have the scale or resources to do stewardship? Should there be a size-limit in order that only the largest firms are caught by the duty?</p> <p>Would it be sufficient to have duty on firms to have arrangements in place that could be satisfied by outsourcing the responsibility to independent providers of engagement and voting?</p> <p>Would this require legislative change or can be achieved via the publication of formal guidance from the DWP or The Pensions Regulator?</p> <p>Should such a duty be framed as a transparency obligation, if not who would be responsible for enforcing the duty?</p> <p>To what extent would a duty result in box-ticking voting behaviour and outsourcing of responsibility to proxy voting agencies?</p>
<p>Reversing the Decline in Equity Ownership</p>		

<p>19. Establish a UK sovereign wealth fund (SWF) to provide long-term equity financing.</p>	<p>In principle, a UK SWF would have a higher risk tolerance and long-term investment horizon.</p> <p>It might help address the equity financing gap left by institutional investors such as pension funds and insurance companies.</p> <p>It can direct funds to support social and economic development goals and investment principles, which could include 'stewardship' and 'purposeful' investment.</p> <p>It could address externalities arising from the gap between private and social returns for a project, which would not receive private financing based on private returns (i.e. act as a multiplier/syndicator for other investors, e.g. as required for renewable energy finance and project finance structures).</p> <p>It enjoys support from both ends of the political spectrum and the asset management industry (e.g. Aviva Investors, Newton, Invesco etc.).</p>	<p>How would the SWF be funded (e.g. debt backed by government guarantee, repurposing the National Employment Savings Trust and/or local government schemes or some other source)? Countries with sovereign wealth funds typically have Balance of Payment (BoP) surpluses, fiscal surpluses, official foreign currency operations etc. – which is not the case in the UK.</p> <p>Which areas/asset classes would it focus on and how would its mandate be structured to ensure investment decisions were made on the basis of economic and financial considerations?</p>
<p>20. Equalise the tax treatment of equity and debt.</p>	<p>At the margin this could encourage equity issuance over debt.</p> <p>Equity finance can be considered more long-term (perpetual contract) and has attractive risk-sharing features. Without equalisation, managers may take on too much debt and hence risk.</p> <p>Evidence of countries that applied an Allowance for Corporate Equity (ACE) system regarding the effect on aggregate capital structure and investment. 2001 corporate tax reform in Croatia as natural experiment, shown to have resulted in increased equity levels and decreased long-term debt levels for SMEs; another quasi-experimental setup based on introduction of ACE in Belgium (in 2006) that provides evidence for an increase in investment activity by small and medium-sized firms (~3% in response to the ACE reform); there has been part adoption of ACE in Brazil but capital structures have not changed much.</p>	<p>What are the advantages of debt relative to equity? Can risk-shifting behaviour be dealt with in other ways?</p> <p>Should policy restrict tax deductibility – if so how would arrangements be phased in (e.g. to ensure the cost of meeting interest payments without tax relief did not undermine solvency for some companies). Or should policy allow corporate equity – if so how would the base of the allowance be computed and the anti-avoidance framework revised to tackle abuses?</p> <p>What lessons can be learned from the experiences of other countries (e.g. Italy and Belgium) for design and implementation, especially regarding ramifications for public finances? What is appropriate and feasible in a UK context?</p>

	<p>Comparison of ACE implementation between Belgium and Italy underlines the importance of complementary measures: The ACE regime installed in Italy -with its incremental character and stricter tax avoidance framework- is viewed as an example of good practice, successfully matching short-run costs with long-term benefits.</p> <p>The Mirrlees Review makes a powerful case for this and sets out how it should be done. What is required is political will.</p>	
<p>21. Extend the already familiar and well-running Employee Stock Ownership Plan (ESOP) to other stakeholders, notably long-term customers, creating a new form of ownership i.e. CuSOPs</p>	<p>Creates financial reward for behaviour that helps create purposeful companies by employees and other stakeholders, such as loyalty, dependence and trust (in ESOPs, stake/vesting often based on a formula proportional to compensation and years of service).</p> <p>By making stakeholders equity owners, it promises to align their interests with those of the company and its shareholders. In turn stakeholders may have greater confidence to make long-term, irreversible investments in the company. It also creates a mechanism to give stakeholders an actual say in the company.</p> <p>ESOPs can help create a hybrid ownership form between pure shareholder and worker ownership (cooperative) structures – which also depends on ownership rights affiliated with employee stocks.</p> <p>Proven precedents/mechanisms in place that could be introduced off-the-shelf with minimal adaptation.</p> <p>CuSOPs would arguably enjoy broader public support than traditional ESOPs.</p>	<p>Is it possible to distinguish between ‘good’ and ‘bad’ sides of patronage (customer loyalty or dependence may be a sign of firm purpose, but in excess it may erode competition)?</p> <p>What practical issues would need to be resolved to implement CuSOPs (e.g. beyond wholesale customers)?</p> <p>What formula would be used to determine a CuSOP stake, given beneficiaries unlike employees in ESOPs, might be harder to delineate?</p>

The Purposeful Company – Call for Evidence

Big Innovation Centre, in partnership with a consortium of FTSE CEOs, Investment Houses, leading Business Schools and Business Consultancy Firms and supported by the Bank of England, has created a two year Taskforce to examine how the UK could boost the numbers and scale of domestically owned, value generating companies.

Following a successful first year of the project, the Interim Report is published in the spring of 2016. It is a comprehensive effort to marshal the evidence supporting the importance of purpose, showing the degree to which Britain's ownership and financial ecosystem is an outlier by international standards so constraining British companies from expressing purpose. It also makes the clear link with the shortfall to the UK economy's indifferent productivity, innovation and investment record.

We are now ready to launch the call for evidence in the next two months to over 20 policy options before publishing the Final Report in the autumn with full policy recommendations and a programme for change and capability building. We are seeking evidence from business, investors, regulators, academia, government, interest groups and members of the public, in particular on the issues and questions raised in each policy option, as soon as possible and before the deadline 20th June.

A full copy of the Interim Report can be found at www.biginnovationcentre.com

Submissions

Please complete the questionnaire online to comment on the 20 policy options or to add additional ones. Alternatively you can send an email or postal submission (both entitled The Purposeful Company Call for Evidence) to Big Innovation Centre, Ergon House, Horseferry Road, London SW1P 2AL.

Generating policy recommendations

The results from the call for evidence will be addressed by the Taskforce in July 2016 at a meeting in the Bank of England and will draw on expertise from the whole economic ecosystem. The results of the policy development work will be published in the Final Report in the autumn of 2016, before moving into project's second phase focusing on implementation, piloting and awareness raising.

The call for evidence seeks input in the form of ideas, evidence and suggestions from all organisations and individuals with an interest in creating the conditions in the UK for economic growth. The 20 policy options we are asking for your input on are contained in Chapter 5 of the Interim Report and are clustered around the themes of:

- Implementation and Remuneration
- Corporate governance and Commitment devices
- Blockholding, Monitoring and Engagement
- Strengthening Asset Manager Capability
- Reversing the Decline in Equity Ownership.

Confidentiality

Submissions will be referenced in the Final Report. Please inform us if you want your contribution anonymised. If you are submitting information on behalf of your organisation, please also include details of the relevant person to contact should we wish to discuss issues raised in your submission.

If you have any questions please contact us on 0203 713 4036, and ask for Brian Wagenbach or Helen Lawrence.

Acknowledgements

This report is a publication from Big Innovation Centre. The content of this report reflects the opinions of its authors and not necessarily the views of Big Innovation Centre or its supporters. Big Innovation Centre is supported by the following companies, public bodies and universities.



Contact details

Big Innovation Centre

Ergon House
Horseferry Road
London SW1P 2AL

www.biginnovationcentre.com

All rights reserved © Big Innovation Centre. No part of this publication may be reproduced, stored in a retrieval system or transmitted, in any form without prior written permission of the publishers. For more information contact h.lawrence@biginnovationcentre.com. Big Innovation Centre Ltd registered as a company limited by shares No. 8613849. Registered address: Ergon House, Horseferry Road, London SW1P 2AL, UK.

