Implementing sustainable corporate governance in Europe: a new vision of corporate purpose

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Building a responsible corporate governance framework is a cornerstone of sustainable companies and should therefore be central to the EU's policies. Together, the articulation of long-term purpose and the introduction of a plurality of voices into corporate governance would allow a better alignment of corporate decision-making with the common good, and operate as a brake on the current systemic tendency towards short- termism.

Creating a more responsible corporate governance model goes together with expressly and legally acknowledging the societal purpose of a corporation, which requires sustainable management and investment, as well as as a policy on the company's environmental and social impacts. There need not be a binary choice between leaving corporate governance in the hands of boards alone or empowering shareholders. They may be counterbalanced by meaningful legal requirements of stakeholder participation in various aspects of corporate governance.

Diagnosing the problem

Short-termism arises because listed companies find themselves subject to relentless capital market pressure to maximise immediate returns to shareholders. A number of mechanisms work together to create this pressure. If investors in a company sell their shares in significant numbers, or if a company fails to meet analysts' quarterly earnings expectations, its share price will decline precipitously (see Millon 2002). Executives hear and frequently accede to the demands of short-term investors for financial engineering in the form of asset sales and increasing leverage, and then distribute 'surplus' cash to the shareholders through dividends and, especially, share buybacks.

Companies which commit large amounts of their cash flow to share buybacks have less money available for investment in research and development (see for example Lazonick 2007), which reduces the long-term profitability of the company in question and harms the innovative capacity of the economy.

The chain of intermediaries between a company and its ultimate shareholders accentuates this pressure for immediate returns, as many asset and investment managers are given incentives and have their performance assessed in ways which are not well aligned with the long-term interests of institutional shareholders such as insurance companies and pension funds (Myners Report 2001).

The same pressure by capital markets forces public companies to cut costs, which leads to environmentally harmful activities, including longer supply chains, products with a shorter life span and wholesale offshoring of jobs. Offshoring reduces employee trust and commitment to companies, leading to lower productivity, a declining skills base and ultimately lower macroeconomic demand in the EU economy (as unemployment increases).

Finally, the current practice of executive pay strongly incentivises executives to focus on short-term share price. Executive remuneration reinforces, rather than works against, the capital market pressure for maximisation of returns to shareholders in the short term. This practice originated in the recommendations of American scholars in the 1970s who successfully promoted the idea of shareholder primacy in corporate

governance, inspired by Milton Friedman's model of the social responsibility of business, which he believed was limited to increasing profits (Friedman 1970).

Short-termism, or myopic behaviour, is the natural human tendency to make decisions in search of immediate gratification at the expense of future returns, decisions which we subsequently regret
John Kay 2012: 14

Wrong focus

Short-termism has very serious adverse effects on companies, their shareholders and their stakeholders, and undermines the macroeconomy.

Companies that increase leverage and sell off assets are able to offer enhanced returns to shareholders in the short term but these kinds of financial restructuring make companies more vulnerable to cyclical downturns over the longer term, as their room for manoeuvre is reduced.

At the EU level, the shareholder value consensus was temporarily shaken in the immediate aftermath of the financial crisis. The de Larosière report concluded that 'shareholders' pressure on management to deliver higher share prices and dividends for investors meant that exceeding expected quarterly earnings became the benchmark for many companies' performance' (de Larosière 2009: 10).

From principle to practice: beyond shareholder empowerment

The following proposals offer an alternative to the current shareholder-centric approach to corporate governance and company law. If adopted, they would contribute to making European companies and the European economy more socially and environmentally sustainable, as well as more innovative.

Specify corporate purpose

EU company law could specify more clearly the societal purpose of companies generally. A clear statement of purpose would:

- clarify what audiences and issues company directors consider to be material for the company
- introduce legal clarity
- empower investors who are concerned with sustainability and disempower who push the corporation to maximise short-term share price
- create a level playing field for companies that wish to contribute to a sustainable and innovative economy.

EU company law could require all Member States to allow companies to specify long-term purposes in their constitutional documents. These statements of purpose might cover environmental, social or scientific goals. In addition, EU company law could require that companies be able to lock-in those purposes against opportunistic change by short-term shareholders (perhaps by requiring a supermajority to amend the purpose clause) (Segrestin and Hatchuel 2012).

The inclusion of long-term (social, environmental or scientific) purposes, either within the corporate constitution or in national companies legislation (as appropriate), would facilitate informed shareholder engagement. It would also prevent the reduction of corporate purpose to the shareholder interest in short-term financial returns. Finally, it would allow enterprises to pursue long-term strategies (especially those involving R&D which entail a high degree of uncertainty), and thereby contribute to long-term economic, social and environmental sustainability. To be effective, the specification of long-term purpose must be accompanied by further changes to the legal and regulatory framework at the national and EU levels, as well as improvements to business practice and culture.

Clarify or expand the fiduciary duties of directors and institutional investors

The EU could clarify or expand the principle of fiduciary duty, or comparable duties. For example, it might create an explicit duty for directors to pursue sustainable value.

This has two important aspects:

(1) the duty of directors/trustees to act in the best interests of the company and **(2)** the duty of investors to invest in beneficiaries' best interests.

Each of these duties is often misinterpreted. In the case of directors, the duty is often misunderstood to be owed to the shareholders, not to the company. Similarly, the duty of institutional investors (e.g. pension fund trustees) is often misstated as being to maximise short-term returns and used to justify ignoring environmental or social risk factors, such as climate change.

Institutional investors could be required to analyse the social impact and as well the financial implications connected to systemic risks. If standarised, the information on investors' policies in given areas could be made a mandatory part of communication with end beneficiaries (e.g. pensioners). These reforms should be coupled with the adjustment of incentives for fund managers to deal with short-term pressures.

Require companies to take into account the long-term interests of all stakeholders

EU company law could encourage or require companies to take into account the long-term interests of all stakeholders, including workers, creditors, communities and shareholders, as well as broader social costs and harm to the environment arising out of their operations. This might be facilitated through provisions which allow these different stakeholder and affected groups to express their views to corporate management and shareholders.

This could begin with a soft law requirement of employee representation on remuneration committees, before moving on to a hard law requirement of minimum levels of employee board-level participation across listed companies.

Employees make illiquid, non-diversifiable investments in the companies for which they work, and so have a longer-term perspective than many shareholders. If policy-makers were to allow them to express that perspective in corporate governance processes, the problem of short-termism would be significantly reduced.

Whilst the European Commission recognises that many Member States require employee representation at board level (see e.g. European Commission 2008), its approach, since the crisis, has been to focus on facilitating employee share ownership rather than strengthening employee participation through increased rights to information, consultation or direct board participation (see European Commission 2010: 17). Furthermore employee representation on remuneration committees was in the revision of the Shareholder Rights Directive but this requirement was not approved at the plenary vote of July 2015.

Review executive pay rules to promote the integration of ESG factors

Other ways of governing executive pay in pursuit of long-termism are conceivable. Restrictions might be imposed on variable pay (including stock options) by, for example, following the Capital Requirements Directive (2013/36/EU) and capping bonuses relative to fixed pay in all listed companies. Revising executive pay structures would continue to provide incentives to executives but would reduce their myopic focus on share price.

Additionally, pay policies could measure performance against both financial and non-financial criteria to capture a range of issues often ignored by stock price, including innovation; and environmental, social and governance (ESG) matters. This could be done by referencing existing standards such as the Integrated Reporting Framework or the Global Reporting Initiative (GRI) Guidelines. Furthermore, ESG requirements of listed companies could be strengthened through a change to the stock exchange listing rules.

The on-going revision of the Shareholder Rights Directive foresees that shareholders will have the power to vote on remuneration policy at least once every three years and potentially veto a remuneration policy that they oppose. The remuneration policy will be required to "explain how it contributes to the long-term interests and sustainability of the company", giving full details of fixed and variable pay. Notably, shares must not be the most significant part of variable pay and financial performance must not be the most important criteria for deciding pay (Morrow 2016).

On the other hand, wherever shareholders have been given an advisory or a binding vote on executive pay, they have very seldom used it to vote against remuneration policies or reports. Remuneration committees have shown themselves to be incapable of producing incentive contracts which address the long-term. Indeed, and potentially in breach of their duty of care to the companies in question, they have not even been able to insert meaningful clawback provisions in executive employment contracts, as recommended by the OECD (2014: para. 112). Thus terminated executives are typically entitled to significant compensation packages unless the board deems their termination to be for a reason for which s/he is responsible, then severance is forfeited (e.g. departing Volkswagen CEO is expected to receive a severance package of approximately 10 million euros).

Correctly aligning management incentives with the interest of long-term shareholders and external stakeholders is crucial to improving corporate governance. Reforming executive pay will not on its own transform corporate behaviour but could have a significant effect when combined with the other changes set out in this briefing.

Incentivise long-term shareholding

In theory, institutional investors with long-term liabilities should purchase and hold shares for the long-term, free from short-term pressures. In practice, they do not do this. One solution would be to encourage these institutional investors to hold their shares for much longer periods. Voting rights might increase (either by law or by default contractual provision) for long-term shareholders, or decrease each time shares are transferred.

Alternatively, capital gains tax applicable to dividends could be reduced on long-term shareholdings. Incentives for long-term shareholding was at one stage envisaged in the revision of the Shareholder Rights Directive but was removed in the plenary vote of July 2015.

Alternatively, changes to accounting regulation and prudential norms might be used to encourage institutional investors to hold shares for periods that match their liabilities (Auvray et al. 2015).

Parliament could also initiate an inquiry (e.g. by expert study) to identify the incentives for short-termism in corporate governance.

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