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THE PURPOSE OF THE CORPORATION

By Paige Morrow and Jeroen Veldman

Paige Morrow and Jeroen Veldman report on the findings of a major global project to identify how companies can create long-term sustainable value.

Between 2014 and 2016 the Purpose of the Corporation Project, with the support of Cass Business School, held a global series of roundtables with more than 260 thought leaders to discuss the foundational question: what is the purpose of the corporation? The roundtable series and research yielded a report, 'Corporate Governance for a Changing World' which provides priorities for corporate governance theory and practice to address.

Since the 1970s, corporate governance models have been narrowing in order to put the maximisation of shareholder value at the centre of corporate attention. The resultant focus on the share price leads to short-termism, undermines a corporations' ability to invest in its future, and diminishes the capacity to anticipate and mitigate systemic risks. The trend is particularly acute in Anglo-Saxon jurisdictions but it is visible worldwide.

Critically examining the move toward shareholder primacy, we found that the definition of corporate purpose determines a corporation's ability to recognise, respect, and balance stakeholder needs, which is key to its long-term success, as well as its ability to operate in line with societal interests, and to maintain public trust and its social license to operate.

Corporate purpose determines a company's ability to recognise, respect, and balance stakeholder needs

The experts in the roundtables agreed that company law worldwide in principle permits a broad perspective on the purpose of the corporation and mandates the direction of fiduciary duties toward the corporation, not the shareholders. Shareholder primacy, therefore, shapes business culture and practice but is not required by law in most jurisdictions, including the U.K. and the U.S.

Defining the purpose of the corporation as the creation of long-term sustainable value while contributing to societal well-being and environmental sustainability, the report contains seven proposals:

Embedding a clear sense of purpose

Embedding purpose requires careful consideration on how to protect the vision and long-term value creation strategy of the company in the constitutional documents. Additionally, a corporation may, where available, consider using an alternative legal form established to protect social purpose, such as the Benefit Corporation, or it could consider retaining a traditional corporate form and certify as a B corporation. In the long-term, it may be appropriate for regulators to consider specifying corporate purpose or requiring corporations to publicly disclose one, as was required for public corporations earlier in history.

Clarifying fiduciary duties

Company directors typically owe their duties to the corporation, not to shareholders. The focus on the long-term success of the company in turn implies that directors should take into account and balance the interests of various stakeholders. Forward-looking directors may reflect these considerations in corporate governance documents, strategic objectives, key performance indicators, corporate reports and executive incentive systems. Regulators may choose to specify directors' duties with respect to the long-term development of the entity, systemic risk and stakeholders. For example, there is currently a debate in the UK about revising the principle of 'enlightened shareholder value' as set out in the Companies Act 2006.

With respect to the obligations of institutional investors, while the term fiduciary duty might not be found in all countries, similar concepts regarding duties of loyalty and prudence exist in most jurisdictions, and require trustees properly to consider long-term financial returns and the management of risk. Although trustees are legally permitted to take account of ESG factors in making investment decisions, the law is vague on the limits of this discretion. It is expected that the law will rapidly evolve in response to emerging challenges such as climate change.

Strengthening the role of the board

While investors have an important role to play in corporate governance, board leadership is fundamental to setting a vision for the company and creating a strong corporate culture. Proposals for strengthening the board include mandating independent directors to represent specific types of stakeholders and setting the corporation's mission, as well as committing to the creation of long-term value.

Governance must be aligned with a strong socially beneficial corporate purpose



Engaging stakeholders

Stakeholders such as employees, customers and creditors have an interest in the long-term success of the company. A corporation's success depends on obtaining resources provided by these stakeholders, who in a broader sense include the natural environment, states, and society at large. Corporate governance documents should therefore specify which audiences and matters are most relevant for the corporation, while directors should consider and report appropriately on how those matters are reflected in strategy. Corporations should also consider effective methods for engaging stakeholders in their governance through representation and/or consultation.

Revising incentive structures

Much of the widely reported loss of public trust in corporate leadership stems from the perception that executive pay is not linked to performance or the provision of overall social utility, and furthermore contributes to intra-firm and macro-level inequality.

Responding to the debate about the need to simplify pay structures and reduce the variable portion, i.e. stock options, the report finds that the variable part of pay may be tied to the creation of long-term value while share-based remuneration may be subject to the achievement and sustainment of long-term goals. Additionally, the introduction of claw-back clauses can give additional security where misconduct is later discovered.

Fostering "patient capital."

Proposals provided by roundtable participants included the use of multiple share classes and allocating rights and incentives to investors on the basis of how long they own shares or how much they contribute to the corporation's capital. Short-termism is often fuelled by a fear that if the share price is low, the company may be vulnerable to takeover or merger bids. A relevant question is therefore what mechanisms should be available to boards of directors to protect the company against unwanted takeovers.

Improving reporting.

There are increasing requirements on companies to disclose ESG information, such as the EU Non-Financial Reporting Directive. The roundtable participants agreed on the need for harmonisation of reporting on the risks of adverse social and environmental impacts connected to the corporation's business, allowing for the internalisation of broad economic, financial, ecological and political risks.

From a corporate governance perspective, the underlying issue is how to disclose this information in a way that combines meeting the needs of investors for an understanding of the firm's value proposition, complying with legal disclosure requirements, and giving an accurate picture of the company to other relevant stakeholders. The International Integrated Reporting framework provides one possible way forward by suggesting how to reconnect reporting to the boards' consideration of risks and their impact on the business model.

Conclusions

The 'Corporate Governance for a Changing World' report shows how diverse groups of actors with a concern about corporate governance can together develop the means to establish a clear sense of corporate purpose, promote the rethinking of corporate governance so it aligns with a strong socially beneficial corporate purpose, and stimulate the creation of new mechanisms for embedding such corporate purpose in corporate governance theory and practice.

The conclusions may help to identify broadly supported policy positions that are compatible with sustainable value creation and systemic market integrity, assist companies working to develop and maintain a focus on longer-term decision-making, and aid institutional investors to fulfil their fiduciary duty to provide sustainable returns to clients and their beneficiaries over a long-term horizon.

"Corporate Governance for a Changing World: Report of a Global Roundtable Series" is available at <https://ssrn.com/abstract=2805497>