May 28, 2019

Corporate Purpose—Stakeholders and Long-Term Growth

Until recently, the dialogue on corporate governance has focused almost exclusively on how to increase the ability of shareholders to impose their will on corporations. Shareholder groups, advisory firms and academics continually developed and added to a set of "best practices" for corporations and their boards of directors, designed to facilitate the ability of shareholders to communicate to corporations what the shareholders wanted and to enforce those dictates if the corporation did not respond. The underlying assumption of this movement was the concept of shareholder primacy. Even the Business Roundtable, in 1997, inexplicably changed from a prior statement of corporate purpose that gave consideration to all stakeholders, to a statement endorsing shareholder primacy: "The Business Roundtable wishes to emphasize that the principal objective of a business enterprise is to generate economic returns to its owners." Policies such as majority voting, proxy access, elimination of classified boards and rights plans, annual say-on-pay votes, the ability of shareholders to call special meetings and act by majority written consent, and other means for the exercise of shareholder power, were periodically promulgated and largely adopted. Short-termism and attacks by activist hedge funds increased exponentially.

The emergence of concern for sustainable long-term growth and ESG factors introduced new elements to the dialogue, but did little to change the underlying assumption of shareholder primacy. Many shareholders did very little other than to tell corporations that they were in favor of sustainable long-term investment and ESG principles and that corporations should be more transparent and keep shareholders current as to their strategy and operations. A few shareholders, principally the index funds such as BlackRock, State Street and Vanguard, published commentaries and wrote letters to investees to say they encouraged companies to adopt sustainable long-term investment policies and to follow good ESG principles. The Investor Stewardship Group later emerged and issued statements in support of long-term investment and responsible stewardship.

In 2016, we produced for the World Economic Forum *The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth*. It was a set of principles designed to foster a balanced, symbiotic relationship between corporations and shareholders that focused not just on corporate behavior, but also on shareholder behavior. It generally adopted the various governance principles that shape the behavior of corporations and their boards, including a full set of engagement principles taken from those published by the major asset managers and institutional investors and from academic articles. But it also sought to provide a set of principles to govern the behavior of investors. For this, *The New Paradigm* first looked at what little had been adopted or published with respect to investor stewardship principles. However, while those stewardship principles provided a useful framework for addressing matters ranging from disclosure to engagement to ESG, they stopped short of providing real assurance to corporations that shareholders are committed to supporting sustainable long-term investment and ESG principles, particularly in situations where such objectives must be weighed against the allure of near-term capital gains. To address this shortfall, *The New Paradigm* articulated an enhanced set of stewardship principles that we hoped would underscore the critical role of shareholders yet tip the scale in favor of a long-term perspective.

Experience over the last several decades, in proxy fights and countless non-public situations involving dialogue between corporations and their shareholders, has shown that corporations today are under tremendous pressure to produce near-term returns. Unless asset managers and institutional investors—who today wield about 80% of the voting power of most public corporations—embrace stewardship principles that commit them to support boards of directors pursuing long-term sustainable investment and ESG principles, short-term pressures will continue to erode the foundation of long-term investments that is essential for our collective economic prosperity. In turn, corporations and the business community will continue to be blamed by the political world for inequality, and the pressure for restrictive legislation will continue.

The crux of this problem is not a legal or fiduciary hurdle. Boards of directors using reasonable business judgment are capable of balancing the interests of all stakeholders—employees, customers, suppliers, shareholders and the communities (including the national economy) in which the corporation operates—if shareholders are ready to support them in doing so. There is no legal impediment to a board in following this path. In addition to stakeholder statutes in some thirty-odd states, the business judgment rule in Delaware and all states would support a board pursuing sustainable long-term investment and ESG principles for the purpose of creating long-term value for the benefit of the corporation and its shareholders. The problem is that only shareholders elect directors, and there is a wide range of perspectives and investment time horizons among shareholders of public companies today. Unless shareholders consistently support the board in managing for the long-term and balancing the interests of all stakeholders, the lowest common denominator will often prevail and long-term investments will be sacrificed for near-term gains.

Two solutions are available. First, the federal government may seek to impose legislation, such as Senator Elizabeth Warren's Accountable Capitalism Act. The Act and our reasons for not supporting it are discussed in these previous memos: *Corporate Governance; Stakeholder Primacy; Federal Incorporation*, *Corporate Governance—The New Paradigm—A Better Way Than Federalization*, and *Further to the Warren Bill, The New Paradigm and a Better Way*. Alternatively, corporations and shareholders may coalesce around acceptance of *The New Paradigm*, including the stewardship principles to be followed by asset managers and institutional investors to assure support for boards of directors that are effectively pursuing sustainable long-term strategies and ESG principles, consistent with those that a number of major asset managers and institutional investors have announced that they are supporting. In addition, asset managers and institutional investors would not invest in activists, would not permit activists to say they have their support, would advise corporations and engage with corporations directly about any concerns as to strategy and operations, and would publicly explain their rationale for any proxy vote that is contrary to the management recommendation. The SEC disclosure rules could be amended to provide for disclosure of these stewardship principles by filers of Form 13F and Schedules 13D and 13G so that they would be on the public record. Actual compliance with the stewardship principles in any particular situation would be left to the interplay between the corporation and its shareholders and the reputation of any shareholder who departs from the stewardship principles it had embraced.

To be sure, shareholders must have flexibility to deal with underperforming companies that are being poorly managed. The foregoing measures would qualify a system of corporate governance that fundamentally empowers shareholders and hinges on their ability and commitment to self-regulate.

On May 20, 2019, the SEC announced it would consider short-termism and its impact on long-term investment and employee compensation. See *SEC to Hold Roundtable on Short-Termism and Interplay with Periodic Reporting System*. In announcing the inquiry, SEC Chairman Jay Clayton said, "The SEC's disclosure rules should reflect and foster these needs—long-term perspective and liquidity when needed. Our public capital markets have a thirst for high-quality, timely and material information regarding company performance and corporate events. Our disclosure rules reflect that thirst for information and, in turn, the confidence of market participants in the quality and timeliness of public company disclosure fosters liquidity. But we should ask ourselves whether our disclosure framework and other regulations have encouraged a focus by companies—and not just securities traders—on the short-term over the long-term." In addition to Congress and the SEC, state governments, stock exchanges, academics, the Business Roundtable and other organizations concerned with our corporate business system are reevaluating their positions on corporate governance and its impact on the economy and society.

We reiterate our advice—*It's Time to Adopt The New Paradigm*; the current version of *The New Paradigm* is part of this memo. The most efficient way to achieve that would be for the Business Roundtable and the Investor Stewardship Group, under the aegis of the SEC, to agree to any further modifications to *The New Paradigm* and then adopt it and recommend that its members adopt it.

Martin Lipton
Steven A. Rosenblum
Karessa L. Cain
Sabastian V. Niles