THE ENIGMA AROUND SHAREHOLDER PRIMACY AND ROLE OF FUTURE BOARDS IN ACCELERATING ITS REPLACEMENT

B. Nandagopal*

"The point is, ladies and gentleman, that greed -- for lack of a better word - is good. Greed is right. Greed works. Greed clarifies, cuts through, and captures the essence of the evolutionary spirit. Greed, in all of its forms - greed for life, for money, for love, knowledge -- has marked the upward surge of mankind".

Wall Street (1987)

When William Oliver Stone penned these lines for his 1987 drama 'Wall Street', he would never have imagined that the United States of America was prancing towards a recession in the following few weeks. But certainly, these words had a gospel effect to many boardrooms during that time. Corporations had slowly started becoming mindful about the stink of greed emitting from their balance sheets. But this period of repentance was indeed short-lived. The infection had to spread as far as American power grew. The pathogen of greed was free riding on its vector of American Capitalism.

The greed narrative cannot spare Europe, Asia and ROW (Rest-of-World) in any milder way. The relentless focus on maximizing shareholder value has resulted in a great divide between the haves and the have-nots. For nearly five decades, the boards increased focus on shareholder pay-outs has come at a high cost. The imprudent assumption that corporate opulence should benefit only shareholders has hurt the ability of other stakeholders to bargain for a share of that prosperity which they also help create.

Etymology of Shareholder Primacy

Why do companies exist? What is the purpose they help resolve ?

Shareholder primacy is a shareholder-centric form of corporate governance that focuses on maximising the value of shareholders before considering the interests of other corporate stakeholders, such as the society, municipal, patrons, and workers. It's an Anglo-American theory that traces its roots from the 1932 classic book 'The Modern Corporation and Private Property' co-authored by a military trained corporate lawyer and an economist bred on neoclassical ethos.

This principle of shareholder primacy has a simple and, in many ways, reflexive logic. It holds that businesses exist first and foremost to promote the wellbeing of their stockholders as possessors of a company's stock – and hence as titleholders of the company itself. After all, it is shareholders who provide risk capital to businesses with the goal of generating returns on invested capital. It is also shareholders who have ownership rights to elect a company's directors to oversee management, and presumably to protect shareholder interests from potential self-dealing by company management or other social pursuits which could distract the company in its mission of yield generation. It is therefore incumbent on company management and boards of directors to serve as agents of shareholders and to promote their interests by generating, if not maximising, profits for the purpose of shareholder wealth creation.

This concept has a legal underpinning through an oft-cited Michigan Supreme Court judgement, Dodge vs. Ford Motor Company, in which the court indicated that "a business corporation is organised and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end". This shareholder-centric perspective was further vulgarized in a 1970 New York Times article by the University of Chicago-based economist, and Nobel Prize laureate, Milton Friedman, titled "The Social Responsibility Of Business Is To Increase Its Profits".

"Have the quarterly target been achieved?"

These are the words said by every member of the senior management at the end of every quarter. Despite their desire to bring great products to their clienteles or meaningful work to their workforces, this question will dictate what a company's true reason for being is. No matter what their intentions, beliefs, principles, or cultural backgrounds are, leaders are obligated to prioritize shareholder profits. A CEO's business decision is subservient to this primary directive. Similar is the case with share owners too. A casual conversation with a retail investor would not surprise you with a common thinking pattern each of them exhibit. Everyone is looking

for the next interim dividend or the next buy-back. Most of them are not in this for the long term. If ever we find someone with a long-term holding, it's because they were naïve about-why they ever owned what they owned.

Achieving targets is directly focused on exponentially increasing the profits for shareholders at any cost. For many centuries companies invested in and depended on a stable workforce, and unions held enough power to secure significant gains for their members. But all that began to change in the seventies. The deceleration of the economy clubbed with the rise in inflation hit the firms plans for sustainable growth. This made shareholders dissatisfied with low dividend pay-outs. A constant demand for a larger share of the profits made boards insensitive to workers, environment and society.

When asked to comment on the free economy, Milton Friedman said, "there is one and only one social responsibility of business - to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition, without deception or fraud."

Though these thoughts were irrelevant in the sixties, they had already sowed the seeds of changes that would germinate a decade later. The Reagan administration made Friedman the Economic Adviser in 1981. Shareholder Primacy went from theory to dogma, and it was assumed that if a corporation did everything it could to pursue profits, all other stakeholders would benefit. Most of the economic writings from that era also started to echo the same sentiments.

Fast-forward to August 2018

Senator Elizabeth Warren introduced a new piece of legislation called the Accountable Capitalism Act. It provided a quick snapshot of how society has arrived at where we are regarding shareholder returns.

The act in brief addressed in the senators words :-

“For most of our country's history, American corporations balanced their responsibilities to all of their stakeholders—employees, shareholders, communities—in corporate decisions...But in the 1980s a new idea quickly took hold: American corporations should focus only on maximizing returns to their shareholders...In the early 1980s, America's biggest companies dedicated less than half of their profits to shareholders and reinvested the rest in the company. But over the last decade, big American companies have dedicated 93% of earnings to shareholders—redirecting trillions of dollars that could have gone to workers and long-term investments.”

This piece of legislation is not only for American corporation alone, but an ideological reflection milestone to all companies across the world. Accountable capitalism is the need of the hour. And for this to get ubiquitous- board leaders need to champion this change.

Capital for accountable capitalism

With tectonic shifts taking place in the process of wealth creation, it's surprising to witness the role of capital in bringing accountability in market operations.

In the early half of 2015, the $800 billion Sovereign Wealth Fund of Norway passed a strong resolution. It had decided to pull-out all investments they had made that were considered harmful to humanity. And the timeline set by the board was 2025. The dirty coal industry was the first to reach the chopping board, followed by weapon manufacturing and finally tobacco waiting for its turn. Many boards across the world were witness to this new flavour of corporate governance. The tasting notes were entirely fresh out here. There was strong essence of environment protection in choosing their investments. The spirit of accountable governance was truly alive in board composition, and the savour of sustainable business practice was indeed bold in every board resolution passed.

Profiting from good business practice

Speaking at the IAA Word Congress in Cochin (India) recently, Paul Polman, the outgoing CEO of Unilever advised companies and brands to urgently build a need to become more responsible in the way they behave and adopt a longer-term outlook if they are to prosper in the difficult times that lie ahead. But his speech had a positive undertone too. He was very candid while saying that Unilever delivered 300 percent shareholder returns by adopting a sustainable development business model over the last ten years. With such writings on the wall, its time our boards start coaching for more socially responsible business strategies from their CEO's.

ESG is the new Global Dominance Strategy

Sometime in mid-February 2019, Avendus Capital had started accepting money for one of India's first funds to base investment decisions on environment, social and governance parameters. In nearly the same time three ex-TATA boys launched the ESG (Enviornmental, Social, Governance) fund for India in partnership with Ajit Dayal of Quantum Advisors. The targeted investment outlay for the proposed fund was a staggering one Billion USD. These are some of the strongest under-currents that indicate to a dynamic change in the form and shape of Capitalism that our next generation is going to witness. The idea of ESG has started becoming a primary talking point in most of the notable boardrooms on this planet. They are being discussed with the same energy and sense of purpose that shareholder returns agenda received a few years ago.

Investing based in ESG strategies stood at nearly $23 trillion at the end of 2015. Sustainable investment is now well-entrenched in Europe and the U.S. While the concept is just getting off the ground in India. If the prime role of a board of directors is oversight, the discipline of ESG needs to be its first baby going forward. Customers have started abandoning brand loyalty with the shrillest misstep their product makers trip on. Similar consciousness has started to dominate the investment community too. Impact Investing or Investing with a Purpose has now become a separate industry taxonomy. If a company needs to sell their wares, service their markets or raise capital- its only ESG that can give them a competitive mileage.

Coaching plan for CEO's

Directors need to enquire, push and stimulate to make sure the company achieves its full potential. When on a board, it's an opportunity to make a difference, provided each board member is well prepared with their boardwork. And most of that opportunity stems from the growing potential of these companies to generate a deep social impact. If you know how to enquire, push and stimulate, you can help your board perform better. Doing so starts with audacity. In my experience, many board members are often reluctant to underwrite actively to discussions for fear that they will appear unfamiliar or cause an awkward ruckus. To be effective, you must overcome that fear. And then you must ask questions. Ask all your questions, even the ones you fear might seem unwise and keep asking them until you figure out what the clever questions are. Then

demand answers to the clever questions. If you don't get good answers to your clever questions, or if you don't get support from your fellow board members when you ask those questions, then resign. Most of these questions will be specific to your company's operational and financial performance. But to be a star board member its prudent to ask five crucial ones that apply to ESG alone.

Question 1

As consumers evaluate our company based on their ESG awareness, what are we doing to build that awareness?

A large percentage of the S&P 500 companies published ESG reports in 2018. End users may not read these reports, but they do read news stories that make claims to being environmentally or socially responsible. They are sensitive to the sham of greenwashing that companies often embark on. So, to begin the coaching journey of the CEO, the boards need to ask the ESG plan that the CEO has in mind. It can be a precursor to entire corporate brand building strategy too.

Question 2.

Does the CEO & Team know where is ESG expressed within the company?

CEO's need to be coached by board members in bringing awareness around what parts of their business can be impacted by ESG - Does the company value chain involve negligent sourcing, miss-management or employee ill-treatment? Is the company's manufacturing process unnecessarily extravagant? Consumers are sensitive to these matters and may reward you for being attentive to them. ESG is also a personal value held by many of the best talents in all industries. In my coaching experience, I have seen prospective leaders — particularly those born after 1975— are interested in making a difference with their work. They want to take their talents to companies that will help them express their values.

Question 3.

What is our criteria for choosing the ESG Agenda?

The CEO needs to select a limited number of criteria to work with. Its wise for the CEO to stick to what is feasible, gaugeable and merchantable. It should be relevant to your company and your defined market. Most companies can find something in the E, S or G categories. For example, if you are a bank your ESG scorecard could have the following elements as recorded in the table below.

Environment 'E'

- Sustainable Lending Impact
- Issuance of green bonds

Social 'S'

- Customer privacy and data security
- Working with regulations

Governance 'G'

- Culture and business conduct
- Risk appetite
- Accounting quality

The answer to a good ESG strategy is not what the process is all about. All this finally lands on the outcomes that they collectively achieve.

Question 4

What is our proactive ESG manifesto?

Confronting ESG proactively rather than reactively may not only hold off detractors. It can also establish you as a leader in your turf, letting you set the bar and frame how other companies in your industry approach these sensitive matters. The greatest benefit of being proactive is that you might uncover the not yet explored areas of ESG that will take on more importance in the years ahead. Setting the bar is not only good for current business, but it is also good for future business. But ESG initiatives take time and planning, and to present yourself as such, you need a lot of research early on.

Question 5

What is our storytelling plan?

Every organisation has a story to tell the world. To institute an image as an ESG leader and reap its benefits in the market, the board and the CEO's office needs to commit to the organisations story. Continuous engagement with your ESG story could help you build a defining mind space within your customers. Sharing your ongoing progress with the public and being ready to refer to data and metrics to back up your story could be critical at this stage. If you lack any of the evidence to provision for your claims, you may be indicted of greenwashing by denigrators and eschewed by potential and existing customers. Incorporating environmental, social and governance matters has gone mainstream. Boards need to sensitise the executive leadership on making ESG an everyday part of their business. They need to appreciate that a dominant ESG strategy will give the company a competitive edge and generous pay off in the marketplace.

Conclusion:

Competition and Strategy are two verbs that dwarf management mind, thought and expression. They brew into a sinister cocktail when fortified with the idea of Shareholder Primacy among its decision echelons. If capitalism needs to survive for the next 100 years, its titans need to relegate the Competition and Strategy words back to a noun form. Its present manifestation has begun to make corporates more inhumane; shareholder returns is the order of the day; profits for the quarter have taken precedence over long-term interests of the society at large.

Only a mindful board can take control of this ideological churn; only an attentive board leader can champion this change and only a conscious board member can challenge the norm. This article would be incomplete if I miss out Late J.R.D Tata as I conclude.

"The wealth gathered by Jamsetji Tata and his sons in half a century of industrial pioneering formed but a minute fraction of the amount by which they enriched the nation. The whole of that wealth is held in trust for the people and used exclusively for their benefit. The cycle is thus complete; what came from the people has gone back to the people many times over." -- J R D Tata ■

*Nandagopal Balagangadharan, PCC, APF, F.IoD is an Executive Coach and a Professional Futurist. He works with clients on Strategy, Transformational Innovation and business ethics.