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Shareholders and Stakeholders:

“the tyranny of the *or*”

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A longstanding debate in corporate governance centres upon a perceived conflict between the interests of shareholders and stakeholders. This is the “faultline” referred to by Juan Miguel Luz in his opening remarks to this panel. In short, it is claimed that companies may serve one, or the other, but not both, - or one only at the expense of the other, in a zero sum game. The workers can get paid more, or the shareholders can have a dividend. The state can have its tax bills paid, or the company can invest for the future. In other words, money can’t be spent twice, and at least one function of the corporate governance regime is to mediate between the competing claims different groups have on the corporation.¹ In this vision of the board’s role, the hapless directors spend their time making trade offs - caught between the demands of investors and employees, between the short term and the long term, between investing to protect the environment or communities and investing for growth. There may necessary tension in defining priorities, but it is unrealistic to see the “faultline” in decisionmaking as falling along split interests of shareholders and stakeholders. Why? Because their core of common interest is in the long term prosperity of the corporation. Hence, shareholders need stakeholder interests to be taken care of by the board. The active and informed shareholder should be the stakeholders’ best friend, because they are the best shot anyone has of keeping the board efficient and accountable.

I want to return to a comment made by Ira Millstein at lunch. He referred to “the tyranny of the *or*” and the importance of replacing “*or*” with “*and*” in our thinking on corporate governance. This is good advice, particular in thinking about shareholders and stakeholders in corporate governance. The advice is all the more compelling because it came from the head of a major

¹ Stakeholder is a recent, and sometimes ill-defined term. It is used in this context to refer to groups with an interest in the corporation, other than creditors and investors. Such groups usually include employees, suppliers, and customers, but at times also the local community and broader society.

company, Ralph Larsen, of Johnson & Johnson² who was asked “Do you serve shareholders, or do you serve stakeholders?” His answer was simple: “Yes”. In other words, as the chief executive of leading corporation, there was no way it could make commercial sense to think about serving one, without serving the other.

This comment does not reflect the ability of one individual to embrace paradox, or coin a bon mot for the press. It reflects the economic and social reality of the commercial world in which directors work. The notion of competing models in corporate governance – of a stakeholder versus a shareholder model – is really only fit for the Venn diagrams of the academic treatise. Shareholders and stakeholders are part and parcel of the corporation – and always have been. Companies provide a means to mobilise capital – and shareholders provide the financial, wherewithal. But this is never enough. Money on its own produces nothing. It is only in combination with human, and at times, physical capital that a corporation comes alive. The genius for wealth creation provided by the corporation, in the form of its board, rests upon the ability to mobilise and allocate, financial, human and physical resources. Paying attention to one, without the other, would simply never work.

It is not only directors of boards that speak publicly, and in blunt terms about this business reality. Shareholders themselves are becoming increasingly active on stakeholder issues, and the reason is simple: enlightened self-interest. The dominant providers of capital are the long term, collective investments of the wider population – namely pension funds. There is no longer a simple divide, with competing interests between separate populations of capitalists, workers and companies. The working population provides the savings which in turn, provide the investment for companies, who intend provide the employment, goods and services and taxes to the public purse which make for a thriving economy.

Where this is not actively reflected in a fully enforced policy on stakeholder relations, shareholders are beginning to realise they should act. Long term investors active in the Anglo-American markets are starting to push boards to actively address stakeholder interests, not from a sense of public purpose or charity, or because they represent special ethical interests³. There

² I am grateful to Holly Gregory, of Weil, Gotshal & Manges for the reference.

³ There is a growing array of investments which are available to shareholders concerned with ethical issues, regardless of financial consequence. Most continue to market themselves upon a reasonable or event superior claim to investment returns, but strictly, ethical criteria for these investors are considered in this context to be the driver for investment choice, rather than a secular view that corporate responsibility makes business sense. Most institutional investors are bound by fiduciary obligations which require them to consider value first.

activist role on stakeholder issues reflects the same fiduciary obligations to enhance value that have led funds to be concerned with corporate governance itself.

Let me provide two brief examples which show how rapidly, and effectively, the influence of pension fund investors is being felt in international markets on stakeholder issues. The first is Shell – a joint Anglo-Dutch corporation, which is one of the world’s largest corporations. The company was besieged by bad publicity in the wake of a decision to dispose of the Brent Spar platform in the North Sea. NGO activists invaded the immense structure and demanded that it be dismantled, claiming danger to the physical environment. This dominated the headlines, and ultimately Shell was forced into a u-turn and changed its plans on disposal. At the same time, an ugly human rights situation in Nigeria ensnared the company, as a brutal dictatorship executed protestors, and Shell was accused of collusion with the military, and widespread environmental degradation. Both episodes exposed the lack of credible strategy on social, ethical and environmental issues, even though the company was an early pioneer in the development of business principles. The situation also exposed a corporate governance weakness in the company’s byzantine structure, which made the board’s control over its several hundred joints ventures tenuous, despite the global brand name. The situation was positively resolved following the intervention of institutional shareholders, co-ordinated by the UK group PIRC⁴, who filed a resolution. This called upon the company to protect its reputation, and thereby, its long term commercial position, by developing a policy that put it at the forefront of the movement for corporate responsibility. It also called for the company to identify board level responsibility for its implementation across the group, and an extensive reporting and verification process to build confidence. The resolution was the first of its kind the UK, and since been followed by others at both BP Amoco and RTZ, filed by consortia of international institutional investors, and backed by NGOs. The upshot at Shell, was that the company had agreed to institute each of the proposals called for by shareholders within several months of the AGM.

The second example is highly relevant to discussion on how these issues might play out in the Asia region. Many of you will have followed the saga last year, when the Chinese government’s hoped for \$5-10 billion capital raising from the IPO of PetroChina, sank to less than \$3 billion in the face of an orchestrated investor boycott in the US and UK markets which were targeted for the issue. Leading funds including some of the world’s largest investors, publicly

⁴ I declare an interest, as the company’s MD at the time of the filing.

stated they would not be buying, citing ethical and governance issues as risks in the company. They made a direct link between these risks, and the value they were seeking as investors. Alan Hevesi, controller of New York's, \$100 billion fund told the press,⁵ "The behaviour of our companies...is of critical importance to the long term performance of our pension funds". An analyst at Prudential Securities was quoted on the slide in expectation "already the target amount to be raised has plunged from \$7 billion last fall to about \$3 billion, in part from the opposition."⁶ Business Week estimated that investors with assets of approximately \$1 trillion had shunned the issue, raising questions about the pipeline of future privatisations.

These two examples show that long term investors are developing a sophisticated sense of value creation in corporations. The financial are, and always will be, fundamental. But what is fascinating to see, is the speed and scale with which the institutional investor community is beginning to appreciate that value is created by the financials working alongside the social, ethical and even environmental dimensions of a company's activities. The phrase "the triple bottom" line caught the imagination of the business community in the 1990s, with a vivid image of a "balance sheet" in three parts, reflecting the financial, social and environmental performance. For the fiduciary investors, such as pension funds, there is still only one bottom line – and their interest in ensuring that the social and environmental issues are factoring into the long term earnings potential.

A recent survey by the AFL-CIO, the USA's trade union federation, provides a glimpse of this integrated "theory of everything" which is emerging in the long term institutional markets.

The unions publish an annual "key votes survey" in which they track the voting records of fund managers of behalf of their members whose assets are tied up in over \$6 trillion of pension fund assets. Looking down the list of issues they consider to be key votes, you would be hard put to draw the line – even the triple bottom line – between them all. The introduction to the report states simply that enhancing long term value is the name of the game, and these are all relevant issues. Examples of the "key votes" include -

- Independent boards
- International labour standards, including use of child labour
- Redemption of, or shareholder voting on, "poison pill" anti-takeover defences

⁵ March 23rd 2000, Wall Street Journal

⁶ April 3rd, 2000, Business Week

- Equal opportunity reporting
- Reporting on environmental liabilities
- Confidential voting for shareholders
- Compensation committees to award executive pay
- Annual voting on the appointment of directors
- Shareholder candidates allowed to the board

Clearly the 'smart money' is no longer looking to segregate portfolios into those which track financial performance, or governance, or corporate responsibility. There is just one investment - the company - which must perform on all fronts. This provides the basis for shareholders' concern with finance (which has always been known and understood) with corporate governance (which protects their interests) and increasingly, with stakeholders.

A bold move to combine these issues, and directly in relation to developing markets, was made recently by one of the largest, and most innovative US pension funds – CalPERS. The board decided (voting 7 in favour, 2 against and with 4 abstentions in a hotly contested debate) to introduce basic screening on social and ethical issues. State Treasurer Angelides explained that the new policy “recognises the correlation between political stability, human rights, and the long term stability and profitability of our investments.” The fund is now engaged in a tough process of developing practical means to implement the policy.

They may be helped by trend setting from another quarter: corporate reporting. In an equally bold move, the UK government in its Company Law Review, proposes that directors be required to report in the OFR on “the company’s purpose, strategy, and drivers of performance...(including) an account of the key stakeholder relations on which the company’s success depends”. If adopted, this requirement in a new Companies Act, will complement existing legislation in the UK Pensions Act, which requires that Trustees disclose any policy on corporate governance, socially responsible investment or environmental issues in their Statement of Investment Principles. The stage looks set in the one of the largest capital markets in the world, for a rapid acceleration in policy disclosure, reporting, and in turn therefore, improved accountability.

This is a vital development. Without rigour in reporting, without clear accountability, stakeholder issues are in danger of forming part of a company’s warm words to the market. Companies cannot be benchmarked across time, across sectors or against the competition. Put

simply, investors – and others in the market – are not able to evaluate (in the old fashioned sense) the information and integrate it into their investment decisions.

The long term, fiduciary shareholders, who represent the wider populations' savings for retirement, will ultimately become the stakeholders' best friend. In the short term, and particularly during corporate restructuring, there will be trade-offs. But for the time horizon of the majority, which is long term, shareholders and stakeholders have a shared interest in the company's sustainable success. Active, responsible shareholders, are fundamental to the protection of stakeholders' interests, not just in the immediate, but through their role in corporate governance. The best insurance for stakeholders to ensure their company thrives, and survives, pays its taxes and does the right thing in the community, is for the shareholders to ensure effective corporate governance. What does this mean? At a minimum, to ensure that the board is competent, independent and demanding of management, transparent in its dealings and responsible in its relations with all parties. For that reason, those concerned with stakeholder interests, should be equally concerned with the shareholder role in corporate governance. At present, financial analysis, governance assessment and corporate responsibility are thought of, and acted upon, in different quarters by different groups. This will surely end, as the contribution of all three are better understood as mutually dependent components of the value creation potential of the company.