Who's Responsible for Irresponsible Business? An Assessment[1]

Colin Mayer*

Abstract: The source of irresponsible business is a systems failure involving an ill-conceived interface between government, the law, investors, and firms. Addressing this systemic failure requires reform of our capitalist system to build a partnership between the four parties that recognizes the function of each and how they should coalesce together.
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* Saïd Business School, University of Oxford, e-mail: colin.mayer@sbs.ox.ac.uk
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I. Introduction

Why is an economics journal devoting an issue to a seemingly management topic and one that might be perceived to be at the relatively 'soft' end of aspirational rather than hard-nosed business at that? The obvious answer is that business is what economics is all or at least largely about. The company lies at the heart of the economy and the successes or failures of economies depend on it.

But there is a more fundamental reason why it is quite right for the *Oxford Review of Economic Policy* to be making this the theme of an issue. Over the last few years the corporation has become an increasing focus for attention and debate. For example, recently it has risen to the fore in the UK, with Theresa May's Conservative government bringing it to the top of its agenda.

The reason for this is that companies have manifestly failed to live up to what was expected of them. There has been a substantial breakdown of trust in them. Originally this was thought to be confined to the financial sector and banks in particular, first with the financial crisis and the need to bail out bankrupt banks at the expense of taxpayers, and then with the unrelenting revelations of misconduct, from the selling of products such as payment protection insurance, to the manipulation of markets such as LIBOR and FOREX.

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More recently, however, we have come to realize that the erosion of trust afflicts many parts of the corporate sector, from automobiles to energy, from food to pharmaceuticals. In the UK alone over the last year we have seen headline-grabbing scandals involving such household names as British Home Stores (BHS), Rolls Royce, Sports Direct, and Tesco. These cases are perceived in the popular mind and press to reflect the worst aspects of corporate culture. Justified or not, as in the case of Guinness and Maxwell in previous decades, the response has been to seek to rein in the unacceptable face of capitalism.

While Britain has perhaps had more than its fair share of corporate scandals recently, it does not by any means stand alone. Germany was shocked by the VW revelations, as was Japan by those of Toshiba, and the US is in the midst of an accounting scandal involving Wells Fargo bank.

What, however, makes the case of the UK particularly interesting is that it believes that it has one of the best corporate governance systems in the world. In the wake of the Maxwell scandal, it established the Cadbury Committee that created the Cadbury code, which has become the model of much corporate governance reform around the world. It has an elaborate system of corporate governance, stewardship, stock market listing, financial market and accounting standards codes, rules, and regulations.

Each time there is a new revelation of corporate malpractice, the immediate reaction is that there has been a failure of regulation and supervision, that rules need to be tightened and enforcement strengthened. And on each occasion, the perception of progress is shattered a few years down the line with further failures and intensified calls for still stronger regulation. If that does not happen, then complacency sets in, there is a gradual erosion of regulation before the next crisis strikes.

The experience of the US is not very different, with the Sarbanes–Oxley Act being a response to some of the largest corporate failures ever in Enron and Worldcom, only for the Act to fail 6 years later in addressing the corporate governance problems revealed by the financial crisis. The further reforms in the Dodd–Frank Act are already the subject of considerable controversy and calls for their repeal.

What's the problem? Is it that we have not yet put the right rules in place or failed to find the appropriate mechanism for enforcing them? Do we need simply to raise the penalties and punishment for misconduct? The evidence to date is not very supportive of a straightforward crime and punishment approach that underlies most law, economics, and finance thinking. There appears to be something more fundamental at issue and, in particular, questions surrounding the premise on which the current system of running our corporate and financial systems is based.

The underlying premise is straightforward. On the one hand there are companies that exist to maximize the interests of their owners, their shareholders, as extolled so eloquently in what is known as the Friedman Doctrine, after its author, Milton Friedman (1970)—'the one and only social purpose of business is to increase its profits'.

On the other side are governments, law-makers, and regulators who set the boundaries within which companies are allowed to pursue their profit-led goals—what are sometimes termed 'the rules of the game'. Subject to respecting the rules of the game, companies can and are encouraged to play as hard and tough as they can in the pursuit of their financial interests. If they stray beyond the permitted boundaries and violate the rules, then they can expect the full force of the law and regulators to bear down upon them.

It is simple, clear, and everyone knows what is expected and permitted of them. The question is, does it and has it worked? Notwithstanding the manifest failures described above, has it on balance been successful in promoting economic prosperity, social welfare, and human wellbeing? Is there an alternative, or have past experiments to try something different demonstrated that, like democracy, it is the worst form of governance, except for all the others?

The purpose of this issue of the *Oxford Review* is to take stock of what has emerged and consider whether the system is so broken as to need fixing or best left as it is without a clearly superior alternative with which to replace it. And above all, this issue seeks to establish whether there are policy instruments that are available to address any failures that may exist. After all, if the *Oxford Review of Economic Policy* is to stray into the realms of business and management, the very least it can be expected to do is bring them back to the hard-nosed reality of economic analysis and policy formulation.

This article argues for a new policy approach to business and the corporation. The existing one views corporations as having a sole purpose in promoting the wealth of its shareholders. Where this runs seriously counter to the interests of the rest of society, then they are constrained in so doing by restraints imposed by regulation. This approach dates back to the appointment of inspectors of railways in the UK in the 1840s and the Interstate Commercial Commission in the US in the 1880s. It expanded rapidly in the 1970s in the US with the creation of the Environmental Protection Agency and in the 1980s in the UK with the privatization of utilities.

The reason that it is wrong is not just that it is unworkable in providing an ineffective constraint on business, but more seriously it is a costly and highly inefficient way of managing an economy. It operates by conflict, pitting companies against regulators, where what is required is cooperation. The sole purpose of business is not to promote the interests of shareholders, and the sole guardian of the public interest is not the government. The role of government is to set a legal and regulatory framework that aligns the interests of the corporate sector with society. It does that through a combination of enabling and prescriptive legislation and regulation that encourages institutions to behave as owners not traders, pursuing the wellbeing of the corporation not just their own. Institutions, in turn, do that through employing directors not as their hired agents to gun down everyone else to minimum cost, but as the promoters of the corporate purpose. This then encourages the flourishing of the corporation that benefits its owners as well as the rest of society.

This is not utopia. It is simple, rational economic conduct and policy design. The source of irresponsible business is not an individual institutional or corporate failure, as it is frequently presented as being, but a systems design problem, and its resolution is reform, not revolution, in the system that we have failed to create in our own image.

II. On purpose

It is almost impossible to pick up a management journal today without seeing reference to 'purpose'. Every company is being urged by every academic to get a purpose and without one they haven't got a life. In exact contradiction to the Friedman Doctrine, what people have in mind when they refer to the purpose of a company is not just to produce profits. The purpose of companies is to produce goods and services and in the process to produce profits. Profits are not *per se* the purpose of companies, but derivative from purpose rather than fundamental.

What is purpose? There are two concepts of purpose—a positive and a normative. The positive is a statement of what the company is there to do—to produce cheap consumer goods, reliable cars, or the largest social networks. The normative is a statement of what the company should do—to look after its employees, to avoid polluting the environment, and to enhance the wellbeing of its local communities and societies within which it operates. The latter has a public-service element that goes beyond the private interests of the company's customers or investors. The distinction that is sometimes drawn is between 'doing good'—the normative—and 'doing well'—the positive.

One reason that this is important is that it is not consistent with most company law. Here is Section 172 of the 2006 UK Companies Act: 'A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole.' The members of the company are essentially its shareholders, so what this is saying is that the director of a company has a fiduciary responsibility to promote the success of a company for the benefit of its shareholders.

The section of the Act then goes on to say that the director must:

> in doing so have regard (amongst other matters) to: (a) the likely consequences of any decision in the long term, (b) the interests of the company's employees, (c) the need to foster the company's business relationships with suppliers, customers and others, (d) the impact of the company's operations on the community and the environment, (e) the desirability of the company maintaining a reputation for high standards of business conduct, and (f) the need to act fairly as between members of the company.

So in promoting the success of the company for the benefit of its shareholders, the directors of the company should have regard for the interests of other stakeholders. However, these are derivative of the requirement to promote the interests of the shareholders and are not a primary duty in their own regard.

Writing in this issue of the journal, Leo Strine, Chief Justice of the Delaware Supreme Court, is still more unequivocal about shareholder primacy in US legislation: 'stockholders are the only corporate constituency with power under our prevailing system of corporate governance' (Strine, 2017). Whether the duty of the directors is to shareholders or stakeholders, or, as the section of the UK Companies Act goes on to say, under certain circumstances, to the company's creditors, the focus is not first and foremost on the company's purpose. The ordering goes from shareholder and possibly other stakeholder interests not from purpose to the company's activities.

Does this matter? To some degree it does because if directors had a fiduciary responsibility to uphold a corporate purpose then they could be held to account for its delivery. In particular, if the purpose had a normative component of doing good as well as doing well, then directors would in principle be obliged to promote a social as well as a private benefit.

There are two reasons why in practice this might not be as significant as it initially looks. The first is that in a private corporation, it is up to the members of the corporation, its shareholders, to seek a remedy for a violation of a breach of fiduciary responsibility. The imposition of the public purpose is therefore dependent on the shareholders' interest in and willingness to do so. If sufficiently publicly spirited, then shareholders might act in this way, but if they are as self-interested in their financial earnings alone, as they are normally depicted as being, then they will not. So the enforcement of a purpose that does any more than promote the financial benefits of shareholders may remain weak, even if purpose was made more prominent in company law than it is at present.

There is a second, and more important reason, why this is probably not the heart of the matter. Shareholders do not in general sue their directors, at least outside of the US. It is for the most part regarded as a complex, expensive, and largely self-defeating exercise if, at the end of the day, any recompense for breach of duty comes from the company itself. In any event there is a potentially more effective and powerful remedy and that is through the market—the market for corporate control. Directors fear the wrath of shareholders through their direct engagement much more than through the courts. It is the telephone call from an activist shareholder backed up by the possibility of a resolution at a shareholder meeting that threatens the survival of corporate directors, and it is this that bears the greatest influence on their behaviour.

Strine provides a graphic illustration of the consequences of these interventions for one of the US's most prominent corporations, DuPont, its hometown of Wilmington, Delaware, and its industry rival and fellow victim of insurgent investors, Dow Chemical Company, with which it subsequently merged.

> When it came down to it, the DuPont board knew who called the shots and surrendered the direction of the company to the prevailing market winds. . . . And, therefore, it was without any apology or shame that DuPont and Dow not only presented their historic home communities with gut-wrenching job losses, facility closures that threatened to hollow out towns, and all the damage to other businesses that came with those decisions, but then asked those home communities to go into the pockets of ordinary taxpayers. (Strine, 2017)

Jack Coffee emphasizes the impact of hedge fund activism on board conduct in the context of the case of Valeant Pharmaceuticals, which according to Coffee, the press described as a 'hedge fund hotel' (Coffee, 2017). It allegedly employed high-powered executive incentive schemes to encourage management to slash costs, shrink the research and development, and raise pharmaceutical prices. More generally, Coffee suggests that the rise of what are termed 'wolf packs'—groups of activist shareholders working together to gain control of a corporate board—has resulted in the appointment of 'blockholder directors'—directors selected by the insurgent investors. As a consequence, Coffee documents the transition of corporate governance in the US from managerial corporatism between 1920 and 1985, through the passive shareholder capitalism that prevailed between 1985 and 2005, to the current system of hedge fund activism.

As Strine says: ‘these powers translate into purpose because those who run corporations owe their continued employment as managers and directors to the only constituency the corporate law establishes—stockholders’ (Strine, 2017). So even if the law required the company to have a clearly defined purpose and directors to uphold that purpose as their fiduciary duty, then it would only be a primary determinant of their behaviour if potential activist shareholders had an interest in societal benefits beyond their own. Otherwise, it will be business as usual with directors focused on what activists regard as the source of shareholder value.

This is not to denigrate corporate purpose, but to suggest that it has been elevated to a status and policy significance that it may not warrant on its own. Tacking purpose on to a system that remains institutionally wedded to shareholder value will not turn the tide of corporate activity in the direction in which purpose wishes it to point. We will need to get closer to the core of the issue and at the core lie three parties—investors, managers, and governments.

III. On the horizon

There is a sharp divide in the responsible business camp between those who see shareholders as a whole as the root of all evil, and those who have a more benign view of shareholders but denigrate a subset of them. In particular, a distinction is frequently drawn between long-term shareholders, who are depicted as the enlightened far-sighted members of society, and the short-term shareholders, who are the parasites of the investor world drawing blood out of hapless corporations from the dividends and share repurchases that they demand of them. It is the short-term shareholders who stand in the way of well-intentioned directors promoting corporate prosperity through the successful realization of long-term investments. Myopia is an affliction of the modern investor; hyperopia is a virtue.

This is as sweeping a generalization as the ‘purpose is good and profits are bad’ school of thought. We would never have invented stock markets if short-term investments were unequivocally detrimental. Instead, we would have locked investors into illiquid, non-tradable assets that they were forced to hold. But in practice, liquidity promotes both capital raising and corporate governance. The ability to trade shares rapidly at low cost is a strong inducement to investment and, in its absence, equity capital would be less readily available than it is today. Correspondingly, in the absence of share trading the only way in which shareholders could register their dissatisfaction with management would be through exercising ‘voice’ at shareholder meetings. With trading they can in addition ‘exit’ through selling shares to other investors better placed to exercise corporate governance than they are. Trading is a source of funding, information, and corporate control. It is as wrong to denounce stock market liquidity and trading as a source of corporate failure as it is to suggest that it is unequivocally good; liquidity assists with stemming fruitless promises.

On the other hand, stable long-term shareholdings are frequently required to fulfil long-term investment plans that would otherwise be prematurely curtailed before they came to fruition. The great merit of financial markets is that they can and do provide both long-term patient and short-term impetuous capital. One of the most striking features of corporations is the rich variety of forms that they take. There is immense variation even within the limited context of corporations publicly listed on stock markets. In some cases, the shareholdings of corporations are highly dispersed among a wide variety of small investors. In others, they are concentrated in a small group of large shareholders with a relatively small proportion of shares freely traded on stock markets.

Corporations are therefore perfectly capable of determining the structures that are suited to their activities. They can promote dispersed shareholdings where the benefits of liquidity and trading outweigh those of more stable concentrated shareholdings. They can establish more long-term stable patterns of ownership where these outweigh the advantages of liquid, traded stock. They can determine the patterns of ownership that they need, provided that they are not impeded from so doing. Only they can't, quite.

IV. In capitals

Alongside long-termism, a second virtue that enlightened corporations are thought to possess is plurality. In contrast to the single-minded focus of the Friedman Doctrine on shareholder value, responsible business expounds the stakeholder view of the merits of promoting the interests of a multiplicity of parties—communities, customers, employees, the environment, future generations, society, and suppliers, as well as investors and shareholders.

On the principle that one cannot manage what one does not measure, this in turn implies that the traditional forms of financial accounting have to be extended to include human capital (employees and suppliers), social capital (communities, customers, and society), natural capital (the environment and future generations), and intellectual capital (knowledge, patents, and R&D), as well as material capital (plant, inventories, and buildings) and financial capital (creditors and shareholders). Profit and loss statements should incorporate 'triple bottom line' measures of environmental, human (and social) as well as financial impact. Performance has to be evaluated on the basis of multiple instead of single indicators, and incentives in organizations have to be aligned accordingly.

This raises obvious concerns about complexity and confusion. Profits bring clarity and precision to management systems that are otherwise plagued by opaqueness and contradictions. Shareholder value is like a laser, a clear shaft of light piercing through a fog of corporate values.

'Not so!' cry the responsible business brigade, citing the oft-quoted phrase that is precisely wrongly attributed to Keynes: 'it is better to be approximately right than precisely wrong'. The laser of shareholder value is an instrument of destruction not creation. Managerial preoccupation with shareholder interests has come at the expense of broader stakeholder contributions that are fundamental to flourishing corporations. Cooking a meal with one ingredient, however carefully prepared, is a recipe for a most distasteful concoction.

As this well-worn debate suggests, there is no clear answer to the question of one or multiple capitals. The multi-capital camp would have a slightly stronger claim to the high ground if it, or we, had a clue about how to measure anything other than financial capital in a half reliable fashion. As it is, beyond crude indicators of human, natural, and social capital and highly subjective means of converting them into monetary units of account, we have very little idea as to how to do this at present. Like it or not, one can observe a stock market price in a way in which it is hard to get a grip on trust.[2] Of course that is no reason for not trying, but we remain a long way from accountants, regulators, investors, and directors devoting the same attention to non-financial as financial information.

But this misses the point. It is not so much an issue of complexity as relevance. There are circumstances in which it is quite appropriate for companies to focus almost exclusively on financial performance—firms that are in financial difficulty or in need of substantial amounts of capital being cases in point. But, equally, there are circumstances in which it is entirely inappropriate: companies that rely on human not financial capital, that manage large amounts of natural capital, that are operating in some of the most socially deprived parts of the world, that are required to deliver public services, are some examples of firms that are or should be obliged to focus on measures of capital other than financial capital.

The appropriate measures of capital and performance are derivative from the firm's purpose. They are determined by what is required to deliver on that purpose. In a very large number of cases, the interests and well-being of the employees and the provision of meaningful work that promotes human dignity and sense of accomplishment is critical and of at least as much, if not greater, significance than return on capital employed. In other cases, the continuity of corporate activities is dependent on

[2] See Henri Servaes and Ane Tamayo (2017) in this issue for a discussion of the measurement of social capital, including trust.

replenishing and enhancing natural resources. For these companies, measurement of human and natural capital is key to the fulfilment of their corporate mission.

We should therefore be no more dismissive of the argument for multiple capitals than its proponents are of its self-righteous rejection by the pure profiteers. Both have their place and neither can survive without the other. Business is not philanthropy and achievement of profit remains a fundamental requirement. But likewise business is not exploitation and profit is not sufficient. It involves willing participation by individuals in the fulfilment of a collective endeavour to which they should feel mutually motivated to contribute. That is only achieved if they believe that their respective interests are reflected in the common currency of corporate success.

V. Doing well by doing good and bad

Faced with an absence of clear theoretical predictions, we are forced to turn to empirical evidence to help establish whether traditional or heterodox concepts of the firm are correct. Does purpose or profit produce better performance? Is long-termism good or bad? Is sustainable, stakeholder business better than shareholder business? Does doing good do well?

There has been a massive outpouring of empirical studies focused on precisely these issues. Henri Servaes and Ane Tamayo survey the literature on the relevance of social capital to corporations in this issue (Servaes and Tamayo, 2017). A decisive study of a relation between responsibility and performance is the Holy Grail to which the business and financial academic community is working frenetically. But like the quest for the Holy Grail, it is proving a bit more elusive than might have been hoped.

On the plus side, there is mounting evidence that if one invests in portfolios of purposeful, sustainable, socially minded corporations and is willing to hold them for a sufficiently long period of time, then one can comfortably outperform their less enlightened and ethically sound counterparts.[3] In this issue, Hao Liang and Luc Renneboog report that corporate donations are associated with higher firm value and better corporate performance (Liang and Renneboog, 2017). But damn it, one also does well with instant gratification investing in 'sin stocks' engaged in gambling, alcohol, tobacco, arms, fossil fuels, and sex. While goodness might be rewarded in heaven, badness appears to have faster (if not such enduring) pay-offs (Hong and Kacperczyk, 2009).

[3] See, for example, Eccles *et al*. (2014).

So what should one conclude from this? The first conclusion is, were it simple, it would have happened. If doing good was so demonstrably superior to anything else, then the last 600 years of corporate history would have been less about rape and pillage and more about eternal sanctity. Second, there are almost certainly areas in which it is possible to do well by doing good. An increasing number of companies, in particular those operating in the developing world, are recognizing this. Third, it is naïve to presume that this is always the case. Much successful business will remain just on the right side of being acceptable. Most companies will cross the line at some time in their history, but equally a large majority will be committed to doing the right thing, given the competitive and other constraints under which they operate.

So not only is theory less than conclusive, so too is the empirical evidence. And there is probably a very good reason why neither is decisive and that is that there is no right answer. There is not a single right way of doing business. Different approaches are required to address the particular purposes and problems of businesses. What is suited to one sector of the economy is very different from another. What is required for a small company is very different from a large one. What is needed in one part of the world is quite different from another. To suggest that there is a correct way of doing business is as inappropriate as proposing that there is a one way to live our lives.

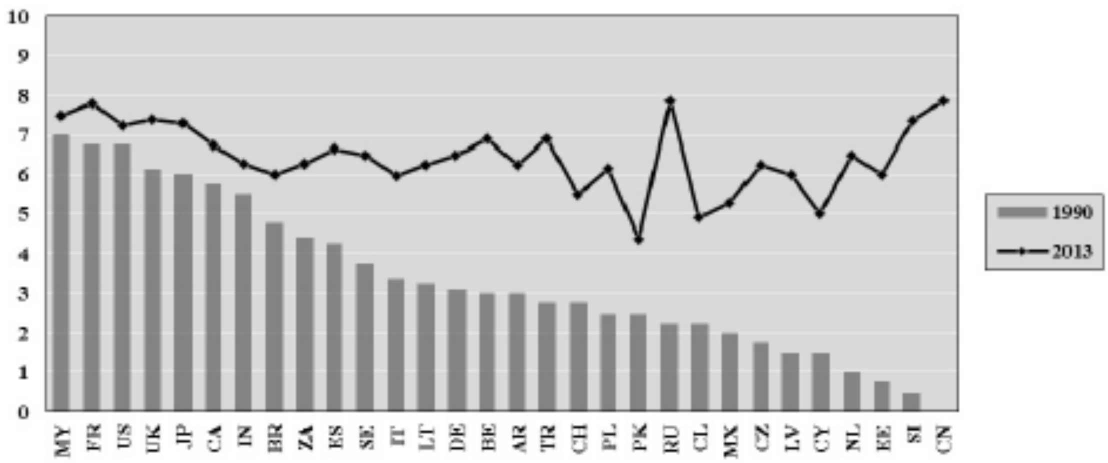
Obvious though this proposition is, the way in which the debate about business has been conducted has not recognized it. Instead, it has been dominated by dogmatic views that there is one and only one lens through which to conceptualize the firm—shareholder or stakeholder, long-term or short-term, environmental or financial capital. And this doctrinal attitude has had a profound influence on the formulation of public policy towards the corporation.

VI. In neutral

Public policy to the corporation has been dominated by an overriding concern—the ‘agency problem’ of aligning the interests of managers with those of their shareholders to avoid unprofitable growth or undue complacency. The common response has been the strengthening of shareholder rights. As Figure 1 shows, there has been a marked increase and convergence in investor protection in all major industrialized countries over the past 20 years. In some countries, such as China, Germany, and the Netherlands, it has been very pronounced. In others, such the UK and US, shareholder protection was already well established at the beginning of the 1990s and has only experienced modest changes since.[4]

[4] Siems, M. (2014); Katelouzou and Siems (2015).

Figure 1: Shareholder protection in 30 countries in 1990 and 2013



Source: Katelouzou and Siems (2015).
Notes: AR Argentina; BE Belgium; BR Brazil; CA Canada; CH Switzerland; CL Chile; CN China; CY Cyprus; CZ Czech Republic; DE Germany; EE Estonia; ES Spain; FR France; IN India; IT Italy; JP Japan; LV Latvia; LT Lithuania; MX Mexico; MY Malaysia; NL Netherlands; PK Pakistan; PL Poland; RU Russia; SE Sweden; SI Slovenia; TR Turkey; UK United Kingdom; US United States; ZA South Africa. Figure 1, from the Law, Finance and Development project at the University of Cambridge, presents an aggregate of 10 variables that act as proxies for shareholder protection law for the years 1990 and 2013. Each variable is scored between 0 and 1, with the possibility of intermediate scores (0 = minimum, 1 = maximum strength of protection). Variables include: powers of the general meeting for *de facto* changes; agenda-setting power; anticipation of shareholder decision facilitated; prohibition of multiple voting rights (super voting rights); independent board members; feasibility of director's dismissal; private enforcement of directors' duties (derivative suit); shareholder action against resolutions of the general meeting; mandatory bid; and disclosure of major share ownership (Siems, 2014).

The justification for the strengthening of shareholder rights is twofold. First, in the context of dispersed ownership systems, such as those in the UK and the US, it provides a countervailing power to that of corporate executives and managers who control corporate assets. Second, in more concentrated ownership systems that are commonplace outside the UK and US, it gives minority investors protection against the dominant shareholders, in particular families, who can exploit their power to the detriment of other shareholders.

If equity markets are to operate efficiently as allocators of resources and monitors of the use of capital, then minority shareholders as residual claimants need to have the means of protecting themselves against both management and dominant shareholders—a truth recognized in nearly all countries.[5] Their rights therefore ensure

[5] Levine (2005) and Demirgüç-Kunt and Maksimovic (2002). For work that focuses on the financing of innovation, see Brown *et al*. (2013).

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that the policies and practices of companies are consistent with value creation not value diversion for the benefits of vested interests.

However, an emphasis on minority shareholder protection comes at a price. It curtails the ability of owners to exercise direct and effective governance, and it prevents management from freeing itself from the tyranny of control by the market. In particular, it limits the ability of companies to structure their activities—their ownership and governance—in a form that is best suited to those activities. While promoting the interests of minority shareholders, investor protection can therefore have unintended and detrimental effects on corporate development.

Examples of such unintended consequences are insider-trading rules discouraging investors from active engagement for fear of making themselves insiders; rights issues requirements raising the cost of companies issuing equity capital; pension fund valuation and insurance company solvency rules discouraging institutions from holding equity capital; stock exchange listing rules discriminating against capital structures that promote committed shareholdings; and absence of takeover defences exposing companies to short-term arbitrageurs during takeover bids.

This is not to say that there is not a strong justification for each of these rules and that on balance they may not be desirable. However, it suggests that regulation should not prescribe either in favour or against particular corporate arrangements. It should as far as possible adopt the same neutral position that is widely advocated for taxation, namely neither encouraging nor discouraging companies from adopting certain types of financial structure or investment policy. It should be for investors and stakeholders to determine what are appropriate corporate forms, not for regulators to prescribe them.

Regulation seeks to restrict activities that are socially detrimental. The article by Robert Mass in this issue (Mass, 2017) illustrates the problems that arise in trying to do this in the context of defining a set of ethical codes for bankers. The nature of financial activities in, for example, trading, sales, and asset management are fundamentally different, and the norms of conduct relevant to them—game playing, persuasion, and guardianship—vary accordingly. The appropriate basis for regulation should therefore be functional rather than institutional; that is to say, regulation should seek to restrict undesirable outcomes and do so through preventing the activities that give rise to them, rather than controlling the institutions that may or may not be associated with them.

If, for example, the harm that is feared of dual class shares or staggered boards is their detrimental impact on minority shareholders, then it is that which should be the subject of regulation, not the proximate cause that may or may not underpin it and may create benefits as well as harms. Institutional regulation is a blunt instrument for correcting corporate failures and is dominated by functional regulation that addresses the failures themselves. This leads to a principle that should be used to scrutinize the merits or otherwise of regulation.

Recommendation 1: Regulation should have a neutral impact and minimize distortions on corporate form.

VII. Enabling

A principle of neutrality flushes out adverse consequences of existing regulations but it does not achieve the positive results of enabling legislation. While the UK and US are frequently regarded as having similar, stock-market-oriented, capitalist systems, their differences are as pronounced as their similarities. One of the most important distinctions is the greater degree of diversity of legal structure and corporate form that exists in the US than the UK. This in large part derives from the fact that much corporate legislation in the US is formulated at a state rather than a federal level.

In that regard, the diversity in corporate form and legislation that exists across Europe might be a more appropriate benchmark than that in the UK. Freedom of incorporation across EU member states in principle provides at least as great a degree of variation as exists in the US. However, one of the consequences of the withdrawal of the UK from the EU is that this variety may no longer be available to UK firms. It emphasizes the importance of diversity at the national as well as the supranational level.

It is sometimes suggested that UK company law achieves this by its permissive nature, namely that S.172 of the 2006 Companies Act permits companies to adopt almost any structure that they choose. But this is incorrect on two scores. First, there are hidden elements of discrimination, regarding, for example, the rights of shareholders to elect their boards of directors, which render mechanisms such as staggered boards infeasible in the UK. This is illustrative of why the adoption of recommendation 1 is potentially of considerable significance.

However, even if there were no such forms of discrimination intended or otherwise, a permissive law is not the same as a facilitating one. In particular, what the US illustrates is how the adoption of laws at a state level has encouraged the development of the judicial expertise that is required for the enforcement of different types of corporate form. To place this in a European context, German courts know how to enforce German-style corporate laws and Swedish courts understand Swedish laws. Without the prod that comes from public law, certain types of arrangements would simply never get off the ground because they would remain unfamiliar to lawyers and courts.

This points to the importance of public laws and regulations in promoting, not just permitting, different types of arrangements. For example, it is sometimes argued that it is not necessary for the UK to adopt a 'Benefit Company'—a company that has a stated public or social as well as private purpose—because it can be achieved under the 2006 Companies Act. But the Act may not achieve the same outcome as a Benefit Company because of the substantial costs and risks involved in being a first mover in its adoption. In other words, innovation in public law is required to achieve innovation in corporate form.

Policy should therefore seek to promote companies of varied legal structures competing in markets regulated by functional rules. This is key to the successful development of purposeful companies because supportive legal structures are critical to their formation. It is not the structure of a corporation that is offensive, any more than it is the genetic make-up of an individual, but the potential actions that either may take. The combination of enabling corporate law that promotes different company structures and functional regulation that targets specific abuses is the basis of the emergence of purposeful firms.

Recommendation 2: Law should enable the adoption of diverse forms of ownership and governance.

The law cannot force good conduct, but it can prevent or promote it. It can be prescriptive and restrictive or enabling and facilitating, and it should know which it is being, where, and why. And when it has to be prescriptive, it should be sure to cause as little collateral damage to invention, innovation, and initiative as possible. The real source of responsibility and irresponsibility is not the law but the people who own and run corporations, and it is to them that we must turn for change.

VIII. Owning up

Long-termism can be as much an affliction as short-termism, just as hyperopia can be as much a defect as myopia. A short-term focus can be of real benefit in delivering results—creating start-ups, changing organizations, and rescuing failing ones—and a presumption that it will be all right in the end can be a recipe for achieving nothing now and destroying everything eventually. Seeing the end tomorrow encourages a beginning today.

On the other hand, that is by no means always the case. There are many activities that genuinely take a long time to come to fruition and achieve their full potential. It wasn't only Rome that wasn't built in a day. It took nearly 50 years to go from the can to the can opener, and in the meantime rather cruder tools such as bayonets had to be used by soldiers who would otherwise have died from starvation in their camps, rather than on the battlefields, contemplating how to open a can without a can opener. It took at least 30 years to go from the first idea of transmitting sound over wires to Alexander Graham Bell 'inventing' the telephone in 1876. And that is before one starts to think about activities such as the provision of infrastructure and utilities and the preservation or destruction of the environment that can have effects that endure for decades, centuries, or eternity.

The reason why myopia is more of a problem in business than hyperopia is not that a short-term focus is inherently bad, but that long-termism takes time. In many cases we literally cannot afford to wait. Jam tomorrow is of little value if you starve today. The future is the luxury of the rich and those who decry the sins of short-termism almost invariably (at least in relative terms) fall in that category. For most, immediate income is of far greater significance than long-term capital gains, which is why quite legitimately financial markets are predominantly skewed towards the former.

That creates a fundamental dilemma—if in fact (contrary to the common proverb) patience is the mother of invention and necessity the source of its demise, then far from promoting economic progress, financial markets can destroy it. They feed our craving for cake today by financing half-baked ones. The fundamental function that we need financial markets to perform is precisely the one that they are ill suited to provide—to convert short-term necessity into long-term opportunities. It is not liquidity that we lack or need; indeed, we are drowning in it. It is precisely the opposite—maturity, risk, and liquidity transformation—the conversion of short-term, low-risk, liquid savings by individuals into long-term, risky, illiquid investments by companies.

This is, of course, the function that we conventionally associate with one part of the financial system, namely banking. As Douglas Diamond elegantly demonstrated in the 1980s, banks are capable of transforming short-term, low-risk, liquid deposits into long-term, risky, illiquid loans by virtue of a simple combination of the law of large numbers and the principle of diversification of risk.[6] Provided that depositors withdraw their deposits randomly and not simultaneously, and so long as the earnings

[6] See Diamond (1984) and Diamond and Dybvig (1983).

of firms are uncorrelated rather than systemically interrelated, then banks can meet depositors' needs to withdraw money on demand at the same time as they fund companies' long-term investments. It is almost as if by magic that the central limit and diversification theorems together extinguish illiquidity and risk.

Regrettably the elegance of theory is not always mirrored in the reality of practice. While in principle banks can be a source of maturity, risk, and liquidity transformation, they often fail to provide it. Far from offering companies long-term risky loans, frequently all that is available are short-term overdraft facilities that can be withdrawn at will by the bank and require the provision of extensive collateral and personal guarantees by the borrower. All too often, the popular depiction of a bank as the lender of an umbrella when it's sunny and the demander of it back when it rains is far from a joke.

Of still greater concern than bank lending is the absence of maturity transformation in equity markets. Savers in general value short-term, safe, liquid investments and, even when saving for retirement, they still attach particular significance to safety. Companies on the other hand require equity to provide a cushion against the risks associated with long-term, illiquid investments. Again, then, financial markets are required to transform the desires of savers into the needs of business.

But what makes the transformation function in equity of greater significance than in banking is that it relates to corporate governance and control as well as financing. While banks are an important source of funding, it is shareholders rather than creditors who exercise control over the way in which companies are run. The particular problem created by a failure of the equity investment chain to transform short-term savings into long-term investments is that it impinges on corporate policy.

There are three reasons why the equity transformation function is underprovided.[7] The first is that there is a market failure in the sense that there is an externality. Banks and institutional investors that transform short-term, safe, liquid savings into long-term, risky, illiquid investments are performing a public function. Some of this is captured through the higher returns that they earn on their investments, but much is not. This is most clearly seen in relation to the governance function that institutional investors perform when they oversee and monitor the companies in which they are investing. They incur considerable costs in terms of the corporate governance departments that they have to employ, but only benefit to the extent that the returns of their own shareholdings are enhanced. The higher returns of other shareholders are an external benefit for which they are not compensated. There is therefore a classic 'free-rider' problem resulting in an under-provision of the governance function.

[7] For a discussion of the problems that arise in the investment chain, see Barton (2017, in this issue).

The second reason is that the transformation function is complex. It requires a combination of knowledge about both finance and management that not many people possess. Those who are best equipped to perform it have had business and industrial as well as financial experience and there are few who fall into that category. This further raises the cost of performing the function and makes institutions dependent on a small number of people with the relevant skills. Furthermore, technology has encouraged institutions to move in exactly the opposite direction by reducing the costs of portfolio diversification and dispersed ownership.

The third factor that militates against the transformation function is regulation. Risk is an anathema to regulators, who perceive their role as being to protect savers and financial systems from failures. They therefore introduce rules on pension funds (such as the 'statutory funding objective' in the UK) that encourage these funds to match their assets with their near certain liabilities to their pensioners through holding low-risk government securities rather than equity. Similarly, solvency rules drive life insurance companies away from corporate equity, with the result that over the last 17 years since the turn of the millennium the percentage of UK equity held by pension funds and life insurance companies has declined dramatically from 50 to 8 per cent. Likewise, the risk weightings that are used in determining bank capital requirements raise the capital costs of investing in high-risk corporate loans as against supposedly low-risk government securities.

For all three reasons, both financing and governance transformation functions are underprovided. This reinforces the significance of recommendation 1 in seeking neutrality in the effect of regulation on corporate form. There are a number of institutions that do perform a transformation function, predominantly outside the UK and US, most notably in Canada, some Scandinavian countries, and in Asia Pacific. The Ontario Teachers' Pension Fund, PGGM in the Netherlands, and the Norwegian and Singaporean sovereign funds are often mentioned in the context of more engaged institutional investors.

There are three things that distinguish these from their more conventional counterparts. The first is that they hold significant share blocks in particular companies for extended periods of time. Second, since they buy and hold these blocks they do not need to employ intermediary fund managers; instead, they manage the investments directly themselves; and third, they invest a significant amount in establishing the necessary in-house expertise. In other words, they demonstrate a commitment to engaged long-term equity investing as against traditional short-term portfolio management They do not forgo the benefits of the latter because they combine engaged concentrated investment in a segment of their holdings with diversified portfolios in the remainder.

In this issue, Dominic Barton describes how two long-term engaged investors incentivize their managers.

> Consider the example of GIC, the Singaporean sovereign wealth fund, which explicitly takes a 20-year view on incentives and performance measurement. Its key performance metric at the aggregate-portfolio level, used as the basis for incentives, is the 20-year rolling rate of return, while its minimum horizon for performance measurement is 5 years. Similarly, the Canada Pension Plan Investment Board has moved to 5-year rolling returns as the benchmark for rewarding its managers. (Barton, 2017)

Likewise, German banks and the regional banks in the US are examples of lenders that have long-term relationships with local small and medium-sized companies. The relationships require banks to have an intimate knowledge of the companies in which they are investing and the capability to be able to support them through periods of financial stress as well prosperity. As in the case of engaged equity institutions, there is an emphasis on informed relationship building that requires more than the credit-rating expertise of a conventional loan officer.

As discussed by Christa Børsting and Steen Thomsen in this issue, a particularly interesting class of owners is industrial foundations, which are widespread in even the largest companies in Denmark and Germany (Børsting and Thomsen, 2017). Industrial foundations are companies that do not simply possess foundations but are owned by them; examples include Bertelsmann, Bosch, Carlsberg, Ikea, and Novo Nordisk. By conventional criteria these companies have all the symptoms of the worst forms of corporate governance—self-appointing boards that are not rewarded on a performance basis or subject to an external market for corporate control. And yet on average their performance is as good as that of other similar companies and, as Børsting and Thomsen (2017) report, in two respects they demonstrate superior performance: they have stronger reputations and better labour relations. In many ways, as John Storey and Graeme Salaman describe in this issue (Storey and Salaman, 2017), they possess similar characteristics to one of the most highly regarded employee-owned firms in the UK, the John Lewis Partnership.

While therefore, there can be no presumption that long-term investing is inherently superior to short-term, there are several factors that have militated against the provision of adequate long-term investing. The conventional retort that efficient markets will not leave money on the table is incorrect. There isn't money on the table for those without the spectacles to see it, the capacity to grasp it, or a free unregulated hand to grab it.

Recommendation 3: Financial institutions should regard the financial and governance transformation of the desires of savers into the needs of business as a primary purpose.

However, while it is conventional to attribute corporate failings to the inadequacies of the financial institutions, they are not the only culprits. Much of the problem resides in the corporate sector itself.

IX. Not managing

Being a responsible businessman is not straightforward. Money and morals are not natural bedfellows. It is easy to say that one does well by doing good, but the truth of the matter is that one generally does a lot better by doing bad. The very act of persuading customers that one's product is the best is a lie for every producer bar one, and only succeeds because it is in general extremely difficult to demonstrate otherwise.

In their book *Phishing for Phools*, George Akerlof and Robert Shiller (2015) provide a compelling demonstration that the problem is much more pernicious than that. Markets have no morals, be they product markets or markets for corporate control. Economic and commercial conduct succeeds by deceit and manipulation, and the invisible hand of markets, whose almost mystical virtues are so widely extolled, is in fact a seedbed of impropriety. Combine that with the fact that the masters of managers are the self-interested, short-term institutional investors of the previous section, and the life of the enlightened chief executive officer (CEO) is not an enriching one—at least not as enriching as it would be were they less enlightened.

That is not to say that enlightened CEOs do not exist; it is just that it is hard to name many of them. Indeed, if one asks most people for examples, beyond Paul Polman, the current CEO of Unilever, few others are forthcoming. Paul Polman's case is illustrative of the problems. He was brave enough to make clear to his institutional investors from the outset how he intended to run Unilever and what he expected of them as well as what they should expect of him. Not many CEOs are willing to do that immediately on appointment and the aborted acquisition of Unilever by Kraft at the beginning of 2017 is a reminder of how even those companies most committed to purpose are exposed to the vagaries of the market.

While important, corporate success is not just about visionary leadership; it is predominantly a matter of innovative management. There is mounting evidence that there are three aspects of management that are associated with doing well by doing good—purpose, practice, and performance. You have to want to do it, you have to bring others along in doing it, and you have to demonstrate you have done it.

An example of a company that embeds responsibility in the core of its business, not as philanthropy, is the John Lewis Partnership (JLP) in the UK. Storey and Salaman note in this issue that:

> the JLP managers place much emphasis on the importance of trust. Trust is the expected response to the successful demonstration that responsibilities are real and are honoured. Managers stress that customers trust the JLP and that is crucial for the success of the business. Customer trust is based on their trust in JLP partners and their confidence that the JLP employment model and values and ownership structure do not prioritize profit above partner or supplier welfare. In other words the JLP's commitment to multiple responsibilities is important in affecting perceptions of the public and the performance of the business and therefore must be maintained. (Storey and Salaman, 2017).

Many companies do not realize the extent to which doing good can be highly profitable as well as socially beneficial. Storey and Salaman quote one group manager at the JLP:

> When Charlie Mayfield became chairman he expressed the Partnership's strategy in these three terms: Partners, Customer Service and Profit. I think what he's now trying to say is, he doesn't want people to think about them as separate. They are completely interlinked. (Storey and Salaman, 2017).

There are profitable opportunities around the world in terms of alleviating poverty, inequality, unemployment, and environmental degradation. The bottom and the middle of the pyramid may not individually have much spending power, but there are unfortunately a lot of them and collectively they can account for a substantial source of revenue, if only one can find a way of reaching them. Similarly, future generations may have little current purchasing power but they are destined to be a lot richer than us and willing to pay for the environment and natural capital if we can protect and preserve it for them. In other words, there are substantial private benefits to be derived from the externalities of poverty and environmental degradation through their commercial internalization. This is not corporate social responsibility (CSR) as meritorious philanthropy, even if, as Liang and Renneboog suggest in this issue, philanthropy enhances firm value—it is poverty alleviation and environmental protection as core corporate activities.

Of course, governments can do a lot to assist with this through creating markets and subsidizing the production of these public goods. But there is a great deal that the corporate sector can do itself, individually and collectively, through relationship and ecosystem building. Amiraslani *et al*. (2017) distinguish between 'endowed trust', that a firm acquires by virtue of the society within which it operates, and 'earned trust', which it establishes by its characteristics and actions. The way in which companies such as Mars and Unilever have gained access to markets in the slums of the poorest cities and the products of farmers in rural communities in developing countries is by building ecosystems and partnering with such organizations as NGOs, other companies, universities, and local and municipal governments.

Even if one is determined to do well by doing good and establishes the ecosystem that is required to achieve it, then there is still a powerful agent acting against it—performance. We know how to measure profits, at least we think we do, but, as was noted above, we do not know how to measure much else. In particular, it is much harder to measure such nebulous concepts as human wellbeing, social capital, and natural capital, or at least to attach monetary values to them with the same precision as profit. There are measures of human, social, and natural capital, but in general they rely on non-market as well as market prices derived from such tenuous sources as surveys of people's preferences and projections of benefits into the distant future that have to be discounted at subjective rates back to the present. As a consequence, even if a company creates good, it is a lot more difficult for it to demonstrate that it is the source of it doing well and to incentivize people to produce the good that is serving them well.

The combination of lack of purpose, practice, and performance militates against the adoption of innovative management methods. This is not only socially damaging but also commercially costly because in essence this is a form of business innovation that is as significant as the technical innovations that are recognized as the source of commercial opportunities. The successful organizations of the future will be those that are able to exploit the remarkable human, social, and environmental as well as technological opportunities of today.

Recommendation 4: Business should recognize, adopt, and measure innovative practices that internalize externalities of human, social, and environmental wellbeing.

X. Conclusions

Recommendation 1: Regulation should have a neutral impact and minimize distortions on corporate form.

Recommendation 2: Law should enable the adoption of diverse forms of ownership and governance.

Recommendation 3: Financial institutions should regard the financial and governance transformation of the desires of savers into the needs of business as a primary purpose.

Recommendation 4: Business should recognize, adopt, and measure innovative practices that internalize externalities of human, social, and environmental wellbeing.

Regulation and the law should promote not impede the enlightened conduct of business. Financial institutions should finance and govern the flourishing of corporations, and businesses should act accordingly in embracing the interests of their stakeholders as well as shareholders.

It is this partnership between government, the judiciary, owners, and business that will convert our increasingly dysfunctional corporate system into one that transforms the lives of all as well as the wealth of the few for the better. We are all irresponsible, not by nature but by being part of a system that makes us so.

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