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Governance of Sustainability Dialogue - ***From Climate Change to Social Change***

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Plenary 6: Governance of Sustainability: Mandatory and Voluntary Drivers

- Alex Edmans, Professor of Finance, London Business School & Academic Director, Centre for Corporate Governance, UK
- Michel de Fabiani, Chair of Policy Committee, Ecoda, France
- Maria Pierdicchi, Director, Unicredit and Chairwoman and Board Member, Nedcommunity, Italy
- Jana Jevcakova, Managing Director, Corporate Governance, Morrow Sodali, Australia
- Chair, George Dallas, Policy Director, ICGN, UK

George Dallas:
Our panel's unifying theme is how best to promote governance and sustainability in practice. We've explored how companies, boards and investors seek to approach sustainability with good corporate governance, responsible investment practices, across an increasingly wide spectrum: financial capital, natural capital, including climate issues, and human capital. Are these market driven effects working? Is there enough real progress in practice? If not, is hard law regulation the best way to promote governance and sustainability, rather than relying on the market or voluntary best practices or principles. The EU's Sustainable Corporate Governance Initiative is our main discussion point, and we'll discuss other global dynamics.

We're generally sympathetic with encouraging responsible governance of sustainability, but there are many variances in achieving this. The EU is a protagonist here. They show great leadership promoting the sustainability agenda, through the Sustainable Finance Initiative, its work on taxonomy and Non-Financial Reporting Initiative, to become SFDR, green bonds and other approaches, which is mostly positive, promoting responsible governance and sustainability, mainly driven by disclosure requirements, rather than physical things. The European Commission apparently feel this isn't adequate.

The Commission concluded a far-reaching consultation on EU company law framework promoting sustainable corporate governance in company law, considering far-reaching changes, e.g., requiring change in Directors' duties to manage all stakeholder needs, and requiring management implementation of due diligence processes, particularly supply chain. In March, European Parliament announced plans for a new law ensuring companies be held accountable and liable for harming or contributing to harming human rights, environment and good governance.
There is appetite for more emphatic regulation. Speaking with the Commission's Governance Team Leader recently, she truly advocates law changes in Director duties and due diligence processes. She's concerned about time horizons and particularly perceived investor short-termism, and that sustainability reporting is insufficiently reliable, without ensuring board processes and due diligence systems in place to make this meaningful.

Too much sustainability reporting may be a public relations exercise, rather than expression of strategic intent, linking to purpose, strategy and operations. ICGN have sympathy with the EU, and share the greater sustainability performance goal, but our response to the consultation was lukewarm to critical. We don't believe meaningful governance and sustainability can be prescribed by regulatory fiat, or that EU's case for introducing hard law prescriptions was strong enough. We're not anti-sustainability, but believe the approach lacks a strong basis in evidence and could have unintentional consequences.

Our panel will cover this academically, from the board, management and investor levels. Alex Edmans, Professor of Finance, London Business School, is a very active commentator in this space, with interesting insights into the consultation and supporting evidence, which contributed to ICGN's response. Alex, how should we look to academics to guide us?

Alex Edmans:
The question is practical, but the evidence is really important, diagnosis precedes treatment. Before deciding how to best address perceived lack of sustainability, what are the problems? I share the objectives of the European Commission Report, but the recommendations aren't fully evidence-based.

In Alice in Wonderful, the Queen of Tarts made some tarts and the knave stole them. He committed a crime and was trialled by the King and Queen. The King requested the jury consider their verdict. The Queen insisted on sentence first and verdict later, decide he's guilty and then contrive to reach the decision. The European Commission's report has this same concern. They argue shareholder value is the cause of all problems, so we need a legislative approach. They only pick supporting evidence for that viewpoint, ignoring many papers published in top journals suggesting otherwise. They argue too much focus is on short-term shareholder value, which is inherently short-term, so we must move towards stakeholder capitalism, which is wrong.

Textbooks teach us shareholder value is a long-term concept. It's the present value of all future company dividends, to eternity. Companies like Tesla are far more valuable than their short-term profits. It's not just semantics. The solution may be, not less, but more, shareholder value and capitalism. It seems heretical, but defining shareholder value as focused on long-term value, rather than short-term earnings, many remedies might be in the shareholder framework. Whilst ensuring Executive pay is tied to long-term stock price, rather than quarterly earnings, may not require abandoning the model, making Executives accountable for something else.

The report pitches shareholders against stakeholders, stating the value the company creates is fixed. Anything going to shareholders is at the expense of stakeholders. Focus on shareholder value means they'll push for dividends and share buybacks, at the expense of wider society. Practising stakeholder capitalism should be anti-shareholder capitalism. We should crackdown on profits, dividends and pay-outs, taking away from shareholders, benefitting stakeholders. It's not supported by evidence.

My book, "Grow the Pie," evidences that "Many things benefit shareholders in the long-term are by-products of creating long-term stakeholder value." As stakeholder model supporters, our greatest enemy is not shareholder value, but managerial capitalism, Managers shrinking the pie for shareholders and society, by failing to innovate, pursuing excellence, coasting, pursuing status quo. Remedies reducing Managers' shareholder accountability, might reduce their overall accountability and lead to shrinkage or failure to innovate.

This shifts thinking on the appropriate remedy. Stock-based pay may be good, because aligning pay to long-term stock price, paying CEOs this way, creates value for shareholders and stakeholders. It's believed shareholders focus on short-term and repurposing companies means reducing engagement, again, no evidence base. A decade's research show hedge-fund activists, blind shareholders, create value for wider society, making companies more innovative and productive. The narrative that companies engaging no share buyback, it affects investment. Evidence shows long-term stock price rises more than short-term, suggesting these things aren't mortgaged in the future. Shareholder pay-outs are reinvested in other fledgling companies, consistent with a purposeful economy.
Whilst agreeing with the European Commission's direction, evidence shows less than ideal recommendations on achieving this.

George Dallas:
A great start. Literature inspires us to think differently. We should maybe look at sustainable governance through the looking glass of the panellists. We're sometimes pressured into choosing shareholder versus stakeholder, possibly a false dichotomy. Maybe approach it with a win-win perspective. Finance 101 teaches discounting cashflow over 50 years, years 1-5 count much more than 45-50. How do we crack that mindset?

Alex Edmans:
Only if cashflows in those years are high. Cashflows in the first years aren't high in some of today's most valuable companies, so large cashflow in years 49-50 will have large weight. Companies are valued on terminal value.

Ford hit record profits in 2016 and 2017, but investor concerns over lack of investment in electric cars decreased stock price, with CEO Mark Fields being fired. Some companies recognise long-term value importance. Investors force companies to move fast on climate, recognising the material sustainability issues for long-term value, because pension funds, etc., with long-term perspectives, consider this.

George Dallas:
Very helpful, thank you. Regarding changing Directors' duties to take account of, and create value for all stakeholders, Maria Pierdicchi, Director at Unicredit and board member at Nedcommunity, Italy, as a Non-Executive Director, what are your views from the boardroom?

Maria Pierdicchi:
As Chair of Nedcommunity, the association of Non-Executive Directors in Italy, and Non-Executive Director and a former Manager, there is hope for progression. Italian Corporate Governance Code asks Directors to pursue sustainable success. The national consensus is this means creating long-term sustainable value, considering stakeholders, defining relevant stakeholders and combining sustainable value creation requested by stakeholders.
The Non-Financial Disclosure emphasised disclosure of main ESG dimensions. 200 companies are covered, which will expand with the new directive. In Ned, the pandemic crisis significantly accelerated dialogue on ESG incorporation into strategy, with ESG Committees, inter-committee work and more shareholder and investor engagement.

Many companies in various industries cannot do sustainable financial performance without considering sustainability and ESG. They are combined and must be incorporated in new strategy and business models. It's difficult to disentangle the two. Investors pressurise companies, with extra engagement, more ESG dialogue, with more granularity than previously. The crisis forced small and large companies to quickly deliver ESG strategy. Family-based companies have moved in this direction, especially in crisis-hit industries.

Too much regulation could harm the process, because it's in place, monitored by important stakeholders, and more formality prevailing on substance, with new regulation intimidating Directors, driving adverse selection regarding duties and liability issues, a serious issue in Italy. Directors can be reluctant to engage, because of their many responsibilities. A reason to work voluntarily is some ESG strategy goals are public goods, which shouldn't be delegated completely to the private sector. The public sector must impose environmental, social and governance regulations and we should share responsibility with them.

Disclosure must be more consistent. It is improving, with many important initiatives. At industry level, we should acknowledge the efforts to develop standards and significant indicators and attempts to transparency in strategy. In Finance, climate change has an important role in ECB stress tests. In Fashion, initiatives with closely monitored supply chains and standards are emerging. The process is in place. We must give our contribution.
Regarding Ned, reaching a sophisticated sustainable strategy requires the necessary skills to seriously challenge CEO and management, providing correct input. Investor engagement policies monitor this. This helps companies to move quickly.

George Dallas:
Are there proposals with positive benefits which would encourage your board to do something you're not currently doing?

Maria Pierdicchi:
There are so many regulations being followed in many areas. Adding more would scare some boards. We should develop good standards, have a consistent European framework, and find a way to express the non-financial reporting more uniformly, and extend coverage of it, an important booster for more commitment. Directors have become more vocal, working more with stakeholders and engaging in outreach. Stakeholders should be part of the process and disclosure, helping combine shareholder and stakeholder interest. We must follow the already established, irreversible trend, not overregulate.

George Dallas:
A clear, useful perspective. Michel de Fabiani, Chair of Policy Committee at ecoDa, France, is actively involved with Boards of Directors across Europe and follows European Union developments closely. From a company board perspective, with a broader geographic base, what's your view?

Michel de Fabiani:
ecoDa, represents 21 countries, including UK, as the voice of over 50,000 European Directors and board members. We're central to board level decision-making.

Seven institutions, concerning businesses, investors, large, listed companies, family business, board members and all kinds of investors, published a common statement on the Commission proposal, showing companies alone cannot resolve all society's ES issues. We must work together with all shareholders and stakeholders.
In several EU countries it's not a new issue, some having very advanced legislations and national codes, e.g., Italy, France, Sweden, the Netherlands, Spain. We see Corporate Governance Codes are key to developing, promoting, advocating for best market practices. We include more stringent recommendations than legislation, the minimum requirement, and are easily adaptable to industry specifics, professional standards and sectors. Codes must be taken into account legislatively and practically.

As Maria said, European legislation brings more coherence. EU legislators must ensure coherence of existing and future legislation, whether Directors' duties, non-financial reporting, taxonomy, sustainable corporate governance. Regardless whether binding or non-binding, legislation should be principle-based and targeted. Framework and principles should be applied to all, with nationally adapted implementation, considering actions already taken, even at regional or city levels. Mayors of the 50 largest European capital cities are more powerful than many legislators, because how to conceive traffic and climate in big cities is an important issue. Don't focus just on legislations, but they should bring general framework for everyone, leaving details to those concerned.

EU common rules should apply to non-European companies operating in EU, making a level playing field with fair competition. ecoDa, some time ago, concluded that board members should ensure sustainable and competitive shareholder and relevant stakeholder value creation. No shareholder means no company, likewise stakeholders: employees, suppliers, customers, so we must work together.

Currently, Europe is well advanced on sustainability issues. Employees are primary stakeholders, they're recognised, present, represented on boards in most European countries. After shareholders, employees make companies exist. They have internal views, differing from management. Boards must incorporate employees and understand them. Board committees, with increasing specialisation: Audit, Finance, Risk, ESG, Stakeholder Committees (considering relevant stakeholders), work hard. We have roadshows, not just finance, but governance, risk, strategy, accessing investors periodically, rather than at AGMs.

The legislation, with principles, frameworks, basic obligations, and codes, with more advanced, specific, sectoral approach, including best practices, and combination of boards with management, ensures the company works appropriately. We favour a generic reporting framework, adapted according to local/national legislation, to sectors, employee numbers, geography. We should do this together, with relevant stakeholders identified, incorporating their views.

George Dallas:
Sustainable governance has existed in European countries in different ways. Is the current governance of sustainability, without required systems, reporting and due diligence processes, as inadequate as presented?

Michel de Fabiani:
European countries differ greatly, some more advanced than others. A minimum platform is welcome. The more advanced should remain so. They can invite less advanced countries to join, but shouldn't impose their best practices. Sectors differ, so practice should be adaptable. Oil and gas have 50 years investment outlook, completely different from chewing gum or distributorship activities. Codes are good, European generic legislation, with minimum obligations, is adaptable to national/company level, with supply chain, human rights issues, employee considerations, equality, fair treatment, etc. Transparent reporting means more visibility and possibilities to improve.

George Dallas:
Jana, as Corporate Governance Managing Director at Morrow Sodali, Australia, you provide shareholder services, serving as intermediary between investor and companies, and can provide investor perspective. Australia has a different objective lens to observe this debate, so, any comparisons or comments?

Jana Jevcakova:
We've discussed voluntary and mandatory corporate sustainability and governance drivers, but one ultimate voluntary driver is money. Call it value, or whatever, it's money, which can be made and saved in ESG.

Academically, Australia has some empirical evidence. Our regulatory framework is one of the worst. Government determined electric cars be extremely expensive and demand extra tax. But we have leading disclosures and performance, companies driving extremely good initiatives, with great momentum, focused on climate change, human rights, etc. The government isn't pushing them, so, what is? From my perspective, the voluntary drivers, largely investors, drive good performance and effort. A positive from COVID is the research it initiated on ESG focused companies. Comparing ESG and traditional fund performance in 2020, the majority outperformed. ESG focused companies are more resilient to withstand crises, and record funds are flowing into ESG. Investors initially sceptical about ESG, are now on board.

Investors can push for better corporate governance and sustainability. They can invest and divest. They're increasingly applying negative/positive ESG screens. Investors report daily that everybody can see financial statements, but Alpha is in ESG, the competitive advantage, the fight for capital access.

Even traditionally passive investors are now very active on engagement, pushing companies for better disclosure, setting targets, disclosing metrics and focus, not just providing boilerplate statements, but focusing on sustainability.

With voting and Maria's point around Directors' views, when there's potential risk of Directors receiving negative investor votes, they become switched on. Correct me if I'm wrong, Maria, but whenever a regulatory framework or mandatory disclosure or requirement is made, very often, Directors consider it a tick box approach, which is pushed to the Legal Department. Directors no longer decide from the risk management perspective. When it's from investors, customers, employees, all stakeholders, Directors pay attention incorporating it into risk management frameworks. ESG is part of risk management, a key duty of Directors. It need not be mandated, written in law. Investors and stakeholders expect it from Boards of Directors, to incorporate policies and framework to protect that value and make money.

George Dallas:
You've started a debate on money versus sustainable value creation.

Alex Edmans:
We have a question highlighting the importance of reviewing the most rigorous evidence. The evidence of Lazonick and others is extremely poor. With basic accounting knowledge, you can see what's wrong. He claims 91% of net income went to investor, "leaving very little for investments in productive capabilities or high income from employees." After one accounting course, you know you deduct wages, research and development, before reaching net income. It doesn't go to wages; they've already been deducted. It's comparable to surmising people haven't had food, because they have empty plates, which are empty because they've eaten.

Because of our confirmation and we've decided buybacks are guilty, people take this as evidence, despite not being published in anything near C level economic journals. Significant research highlights the errors, taking the data and evaluating it. My article, "The Case for Stock Buybacks," and articles by Jesse Fried and Charlie Wang of Harvard, show rigorous evidence that share buybacks are not the cause. Short-termism is a problem, with causes, e.g. quarterly earnings, short-term CEO pay, but not buybacks.

John Kay, who hasn't published papers in a recognised journal and has no PhD, the minimum qualification for scientific research, critiqued the British Government, stating, "Odysseus was short-termist because he needed to be reined in and not to go to the sirens," Using Greek myth as short-termism evidence is a problem. He mentions Milton Friedman's 50 year old discredited polemic. People often look at it, saying, "Business responsibility is increasing profits, which is short-termist and evil." The article is very nuanced. I wrote about why we might take Friedman seriously, despite being a stakeholder capitalist. I'm not a fan, but my whole career has been stakeholder capitalism. My book describes why he's wrong, but we shouldn't dismiss him without reading, listen to his views and try to understand them.

I agree that claiming shareholder value is inherently long-term defies analysis of John Kay. Assuming his analysis was entirely correct, the current model is completely short-termist, doesn't contradict shareholder value being long-term, but we aren't practising long-term shareholder value. We practice quarterly capitalism, focusing too much on quarterly earnings, so the system may be too short-termist, but we must move to a long-term system, not a problematic system involving micromanagement. We must understand the issue might be short-termism versus long-termism, rather than shareholder versus stakeholder.

George Dallas:
Considering tighter valuations, should we consider the need to preserve value, not create it? Maria, your views?

Maria Pierdicchi:
It's important. With the pandemic, value preservation in certain industries is a priority, which doesn't mean opposition with long-term value creation. Preserving in crisis helps you reinvest and reinvent yourself within the new framework after the crisis. If banks hadn't been in defence, they wouldn't be ready now to support the economy's recovery. They're not opposite and you must take risks in supporting sustainable value creation strategies. Some investments don't give expected return, which is entrepreneurship, risks can't be avoided. Value preservation is important in these times, but, long-term, value preservation can fail if, for many reasons, investments don't give expected return.

The value of corporate codes is culturally, very important in each system. When small companies hire Executive Directors, the bank's mark of governance is the corporate code. You may not agree, but you look and start developing a governance structure. We must emphasise the cultural value of good governance through codes. It improves all industrial systems it operates in.

Jana Jevcakova:
Agreed. On my comments referencing money, many associate it with short-termism, but companies having sustainable ability to create money. You might invest, or report impairments for better ability to make money later, whilst incorporating risk management and sustainability considerations in decision-making.

Highlighting the business sense of sustainability and ESG, increasingly, more Millennials are gaining purchasing power, getting money, who make very different decisions to Baby Boomers, etc. They consider where products are from, its sustainability, its possible long-term use. There's hypocrisy with technology, but overall, they will very quickly drive changes.

Increasingly, employees choose their employer from sustainability considerations, the conditions and perks they provide. Without the company's ability to make money, they can't attract the right talent, and won't create or preserve value.

Australia has many cases of mining companies impacting communities negatively, impacting their social licence to operate. Influences may not have an immediate impact on share price, an ongoing expense is associated with any potential damage to a social licence to operate and enormous, unqualifiable, reputational damage.

Bankers and financers are increasingly pushed to act appropriately and focus on sustainability. Increasingly, they assess companies asking for loans and provide better conditions, performing well on disclosure and scrutinising sustainability overall, as it's less risky for debt repayment.

George Dallas:
Michel, any comments on anything, and should companies who care about sustainability consider doing good for their stakeholders, rather than not doing harm?

Michel de Fabiani:
The key point for boards, the heart of companies, is ensuring strategies are based on good governance. Review all risks, impact of activities, mitigation and improvement you can make, ensure ESG targets are in strategies, business plans, budgets, any targeted activity, and ensure ESG is a competitive advantage long-term. Europe should use ESG. In some sectors, leading in ESG means you will lead the sector. Be transparent, report appropriate information, not just at AGMs, but ongoing, at roadshows, and internet information. From AGMs with few shareholders, we now have periodical reviews of all activities and information, with relevant stakeholders, those concerned directly/indirectly by your activity. Not all stakeholders or shareholders are relevant.

George Dallas:
Should shareholders have the right to vote on ESG/CSR issues?

Jana Jevcakova:
They have the right, but it doesn't have to be votes on climate or ESG. They can vote against Directors if unhappy with risk and ESG management. Both give good insight into next steps.

Maria Pierdicchi:
They have the right to monitor ESG policies in different ways and to accelerate change. Voting may be too complicated to get a very clear understanding.

Michel de Fabiani:
They can vote at AGMs at least yearly, and for board members' renewal/non-renewal. They can keep shares or not, which is also a way of voting.

George Dallas:
The Wall Street vote.

Alex Edmans:
I wrote an article in the Wall Street Journal on this. It shouldn't be ubiquitous or mandatory, and sometimes isn't necessary. Votes should be on objectives. Shareholders in companies with non-financial objectives should have a say in those objectives, without micromanaging. The board is responsible for achieving objectives. Shareholders may want a say on potential trade-offs between decarbonisation and preserving employment, so it's a useful resource.