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Article Highlights:

- A broader set of stakeholders' rights matter in business today due to a convergence of three trends: governance as a strategic tool, enlightened markets and the impact of ethics on business results.
- Thoughtful exchanges in discussions about public relations, mergers and acquisitions, and climate risk as a disruptor suggest that directors accept that corporations need to account for broader interests because they all impact shareholder value, rendering them important market forces in and of themselves.
- The trends are strong and straightforward and changes they suggest in corporate governance are achievable. Strong board leadership is the intangible ingredient directors must provide to respond to the market's call for ethics.

Market Forces Make a Case for Ethics in Governance

Written by Ann Skeet

The argument supporting shareholder primacy has been around since Milton Freidman declared it sacrosanct in the early 1970s. Shareholder primacy is considered a bedrock of corporate law but I believe this is changing. A broader set of stakeholders' rights matter in business today due to a convergence of three trends: governance as a strategic tool, enlightened markets and the impact of ethics on business results. The work of scholars and business leaders should fuel the courage of people serving in board and management roles to continue to think broadly about their responsibilities: to set goals to be realized over the long term, to serve interests beyond just those of financial investors, and to actively design the larger business system they operate within to promote ethical behavior, considering a broad set of stakeholders.

Governance as Strategy

Increasingly, how boards are structured and operate have themselves become elements of corporate strategy.

Companies go public to raise capital, and by adding owners to spread risk among a new group of shareholders. Rights and risk are typically aligned. But some established, high-profile public companies, like Facebook and Google, and some just entering the public markets like Snap, Inc., have deployed stockholder class structures that uncouple ownership rights from risk. This leaves non-majority shareholders without input on matters usually associated with such rights, including board composition and executive pay. According to the Council of Institutional Investors, companies with a controlling shareholder tend to underperform those without one.[1] This puts more pressure on board members to represent those rights and the corporation's interests.

There are other recommendations being made to heighten transparency and rebuild trust that support the interests of a broader set of stakeholders.

A working paper, published in September 2015 by Robert Eccles and Tim Youmans at Harvard Business School, details laws around the globe in search for support of shareholders primacy.[2] Eccles and Youmans claim this is ideology only, not law.

Shareholder value, they contend, is an outcome of how a corporation's capital is used, not the objective of the corporation. Eccles and Youmans recommend adding a "statement of material audiences" to the set of corporate reports legally required to improve transparency and advance understanding of a corporation's intent and time horizon, thus bringing stakeholder's interests forward.[3]

Others in business today are trying to counter a trend in activist shareholders driving corporate decision-making for the short-term by reminding corporations of their ability to consider the long-term as an appropriate timeline over which to create value, a position notably taken by Larry Fink at Black Rock. Mr. Fink reminded us in a letter publicized in business media in 2015 that a director's duty of care is to the corporation, not to individual shareholders.[4] This commentary from business leaders is another sign that the pendulum may be swinging towards broader stakeholder interests.

Markets are Enlightened

Another sign is that consumers of products and investors are also signaling that a broader set of stakeholders should be considered. Evidence of this shift can be found in the reporting of ESG factors to assess corporate performance. These measure a corporation's impact on the environment, its sustainability--which is growing to include concepts like fair compensation--and governance. Lists of companies' ESG measurements are being linked to shareholder return, reinforcing the point that considering stakeholders more broadly is consistent with meeting obligations to shareholders.[5]

"Market forces that are bringing ethics to the forefront should continue to shape boardroom agendas. Three tools boards can use to provide ethical leadership are: use of mission, attention to ethical systems design and increasing board diversity."

Since 2011 The Global Impact Investing Network (GIIN) has surveyed a growing group of funds, foundations and other assorted financial intuitions regarding impact investing. They claim that in 2015 their survey respondents reported total assets of $35.5 billion, an 18% increase since 2013.[6] A J.P Morgan report suggests that impact investors have roughly $60 billion of AUM.[7] The introduction of KKR's Green Portfolio, in partnership with the Environmental Defense Fund in 2007, is another example of how environmental impact is being accounted for in business, but these are not the only ways.

Thoughtful exchanges in discussions about public relations, mergers and acquisitions, and climate risk as a disruptor suggest that directors accept that corporations need to account for broader interests because they all impact shareholder value, rendering them important market forces in and of themselves.

Demographic trends, like the increase of millennials in the workforce, introduce a need to consider what those workers are seeking in their relationship with employers and how they are behaving in the marketplace as consumers.

Millennials are more likely than non-millennials to be receptive to cause-based marketing: 37% of millennials said they would likely buy a product supporting a good cause versus 30% of non-millennials.[8] The market is elevating stakeholder interests.

Ethics Affect Business Results

Ethics is having its day. Across all sectors, attention is being paid to the ethical behavior of executives and corporate boards. Companies are considering the appointment of stand-alone ethics officers and other measures after decades of ethics code writing and training have done little to improve behavior in business. Articles about risks in 2017 have been including business ethics issues in their top ten lists regularly. Recent business scandals, such as Wells Fargo and Volkswagen, have raised questions about corporate leadership and oversight. CEO reputation, conflicts of interest and board management of business ethics risks are current hot topics.

In an April 2015 HBR article about leadership character and effectiveness, a study by KRW International was cited in which researchers found that CEOs whose employees gave them high marks for character had an average return on assets of 9:35% over a two-year period, nearly five times as much as those with low character.[9] Fred Kiel and his researchers identified four moral principles--integrity, responsibility, forgiveness and compassion--found to be universal and then measured CEOs on these attributes. "Virtuoso" CEOs received high ratings on all four principles and were identified with standing up for what's right, expressing concern for the common good, letting go of mistakes and showing empathy. At the other end of the spectrum, CEOs who were of low moral character were identified as "self-focused" CEOs. Employees recognized these CEOs as being most concerned with personal gain and their own financial security. In other words, they did not represent correct interests while serving in a formal leadership role, but instead focused on their own interests. The body of research on CEO reputation suggests that the quality of executive leadership and ethical practice aids boards in their important task of hiring new executive leadership.

At a Stanford Rock Center for Corporate Governance program in 2015, a lead M&A investment banker made the case for ethical boardroom behavior, citing a string of recent Delaware court cases in the realm of investment banking where even the appearance of a conflict of interest proved problematic for bankers being hired to work on deals. This standard has not been widely accepted in banking but appears to be on the rise of normative behavior. Tolerance for conflict of interest is lower in the current political climate, given the level of scrutiny it has received as business leaders have been tapped for roles in the current administration. Furthermore, regulatory moves like the Yates memo issued by the DOJ in 2015 suggest there is scrutiny on individual actors in corporate settings.[10]

Implications for Boards

Market forces that are bringing ethics to the forefront should continue to shape boardroom agendas. Three tools boards can use to provide ethical leadership are: use of mission, attention to ethical systems design and increasing board diversity.

If there is a resource that may be overlooked by boards in the clutches of a critical decision, it is the organization's mission statement. The organization's mission is a point of union between governing bodies and management teams aligning the interests trustees represent with those represented by management. Developing high utility missions that achieve this interest alignment, identify core values, and are used in decision-making is one key way boards can affect business ethics.

A recent example that mission matters is the Volkswagen brand crisis. Volkswagen doesn't have a mission statement. It stated values in its 2006 annual report, but they disappeared in future years. By 2010, Volkswagen joined 21 other German automakers in agreeing to a "mission statement for responsible actions in business" but still operated without a clear core set of defined beliefs or values to guide VW's work, or a motivational reward system aligned with a mission. A 2013 analysis by Strategic Management Insight found Volkswagen Group's goal lacked any statement of values or philosophy and did not mention customers, employees, or technology.

Mission statements are one piece of ethical design. Designing ethical systems requires acknowledging that people have different roles, levels of influence and power. Considering these "restrictions and enablements" present for people within an organization, and how they influence human behavior, is the work of leadership.[11] People are influenced in their employment and behavior in markets by the circumstances of their life so these realities must be acknowledged.

If enablements (i.e. extremely high compensation) or restrictions (some people receiving fewer benefits or less freedom to plan their work, i.e. some people are employees with benefits and others only contractors without job security or benefits) vary across an organization without consideration of fairness, rights and compassion, organizations lose not only the loyalty and good feeling of their employees, but real returns to stakeholders. Systems such as these are not designed to promote ethical behavior and will erode shareholder value. In my opinion, this is the story behind the customer service breakdown experienced at Wells Fargo in 2016.

Much lip service and some modest improvement have been achieved in diversifying boards. Emphasis has been on gender and ethnic diversity and those are good moves to be sure companies are in touch with different aspects of their enlightened markets, but to be sure this is true, adding board members representative of broader age and interest group demographics also makes sense. Boards serious about ethical systems design will have members who come from within the ranks of organizations where that design happens.

Trends		**Implication**
Governance as Strategy	suggests	Mission Matters
Enlightened Markets		Broader Board Diversity
Ethics as a Business Risk		Ethical Systems Design

The trends are strong and straightforward and changes they suggest in corporate governance are achievable. Strong board leadership is the intangible ingredient directors must provide to respond to the market's call for ethics.

Endnotes

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About the Author

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Ann (Gregg) Skeet is the Markkula Center's Director of Leadership Ethics, a position that directs the Center's work in business ethics, nonprofit ethics and considers the unique ethical concerns of those in leadership positions. Ann served as CEO of American Leadership Forum Silicon Valley for 8 years and previously for Knight Ridder at the San Jose Mercury News for a decade. In her last role there she served as Vice President of Marketing for the San Jose Mercury News and Contra Costa Times.

In the Silicon Valley community, Ann currently serves on the board for Children's Musical Theater San Jose and the Silicon Valley Directors' Exchange. She has served on the board of directors for numerous organizations, including the United Way Silicon Valley, the American Musical Theatre of San Jose, the Harvard Business School Association of Northern California, the Children's Discovery Museum, Hillbrook School, the Silicon Valley Conference for Community, Catholic Community Foundation of Silicon Valley and Justice (now SV Faces), the Stanford Daily, and the Nonprofit Development Center (now CompassPoint Nonprofit Services). She is a founder of 1st ACT Silicon Valley.

Ann is a magna cum laude graduate of Bucknell University and member of Phi Beta Kappa. She holds a master of business administration degree from Harvard Business School and spent her early career working in outside plant for C&P Telephone Company in the Washington, D.C. area, her hometown.

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