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Global Asset Managers and the Rise of Long Term Sustainable Value

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EXECUTIVE SUMMARY

- The largest global asset managers (e.g., BlackRock, State Street) have stated that long term sustainable value (LTSV) is their key goal with respect to the firms in which they invest.
- LTSV is about both economic performance and societal impact making it appear somewhat broader than traditional conceptions of shareholder primacy.
- Given the large amount of assets under management with these firms, their views on corporate purpose are likely to have significant effects on firms around the world, regardless of what the underlying legal regime may require.
- LTSV focuses board attention on enhancing strategic discussions for long term economic and societal effects, regular engagement with investors on these issues evincing a desire for a more collaborative framework, and a focus on risk management, amongst others.
- Indian Corporates may wish to consider how these developments are likely to influence their attempts to raise capital along with considering some steps suggested in this briefing to navigate this terrain.

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I. Global Asset Managers and Corporate Governance

Over the last decade or so, the purpose(s) of a corporation has become a source of considerable debate across national legislatures, corporate boardrooms, media newscasts, and other venues. A number of countries have reformed their corporate law regimes and there are proposals to do so in many other countries, including the U.S. Although these changes are significant, another change has begun to capture the attention of those working in corporate governance. Global Asset Managers, such as BlackRock, State Street and Vanguard, have explicitly stated that they would prefer a different paradigm for interacting with the managements of the firms in which they invest. Perhaps the most prominent statement of this has been the letter to CEOs by Larry Fink, the CEO of BlackRock, in January 2018, which says:

> To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate.
>
> Without a sense of purpose, no company, either public or private, can achieve its full potential. It will ultimately lose the license to operate from key stakeholders. It will succumb to short-term pressures to distribute earnings, and, in the process, sacrifice investments in employee development, innovation, and capital expenditures that are necessary for long-term growth. It will remain exposed to activist campaigns that articulate a clearer goal, even if that goal serves only the shortest and narrowest of objectives. And ultimately, that company will provide subpar returns to the investors who depend on it to finance their retirement, home purchases, or higher education. [2]

This is an important statement coming from the CEO of the largest asset manager in the world – with approximately USD 6 Trillion in Assets Under Management (AUM) – and the statement is consistent with those from other larger players in the asset management industry, which represents, at least, USD 20 Trillion in AUM. Moreover, these firms regularly place large amounts of their capital in indexed funds, which often makes them longer-term investors. [3] This may arguably lead them to have somewhat different interests than those of the hedge fund activists we have become familiar with over the last few years. How these asset management firms direct their sizeable capital can have important ramifications for corporate governance. This briefing lays out the background to these developments, what we know about what this new paradigm suggests, and what Indian corporates may wish to consider in order to be prepared.

II. Background on the Rise of Long Term Sustainable Value

There are two major schools of thought on the aims of the corporation: shareholder primacy and stakeholder theory (recent NSE briefing has addressed these). [4] The former suggests that the corporation ought to be run primarily for the benefit of shareholders (i.e., to maximize their wealth). [5] The latter school of thought suggests that corporations ought to be run for the benefit of all stakeholders, and not primarily for shareholders. [6] This vision of the corporation's purpose leaves room for debate on many issues, including who are the stakeholders (e.g., employees, the environment, the government), how should their interests be balanced when they seem to conflict, and how can non-shareholder stakeholders enforce their concerns (e.g., should they have rights to bring derivative suits against the board and management). Jurisdictions may resolve these concerns differently (see Box 1), but they typically start from the premise that corporate forms can, or perhaps should, consider stakeholder concerns in some manner.

2 Letter to CEOs, Larry Fink, Founder, Chairman and CEO of BlackRock, Inc., January 17, 2018. Available at: https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter. See also Larry Fink, *A Sense of Purpose*, Harv. L. School F. on Corp. Governance and Fin. Reg., Jan. 17, 2018, https://corpgov.law.harvard.edu/2018/01/17/a-sense-of-purpose/.

3 See response and commentary to Fink letter, e.g., Abe Friedman, *BlackRock's Call for Companies to Deliver Financial & Social Value*, Harv. L. School F. on Corp. Governance and Fin. Reg., (Feb. 6, 2018), https://corpgov.law.harvard.edu/2018/02/06/blackrocks-call-for-companies-to-deliver-financial-social-value/. The effect of indexing and LTSV on ESG is not addressed in this briefing.

4 See Umakanth Varottil & Mihir Naniwadekar, *The Stakeholder Responsibility of Corporate Boards*, NSE-CECG: Quarterly Briefing, January 2018. Available at: https://www.nseindia.com/research/content/res_QBJanuary18.pdf.

5 The shareholder primacy view does not mean that management cannot do things that benefit non-shareholder constituencies (otherwise donations to philanthropic causes would be problematic), but rather that the measures to benefit non-shareholders must be thought by the board and management to benefit shareholders in some manner.

6 See Thomas Donaldson and Lee E. Preston, The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications, 20 Academy of Management Rev. 1, (Jan. 1, 1995), https://doi.org/10.5465/amr.1995.9503271992.

Although support for stakeholder theories may come from many different sources (e.g., concerns about labor, income inequality, the environment), the current interest seems connected to fairly recent economic and market developments. For example, the rise of investor activism (especially Hedge Fund activism) in the US and elsewhere has attracted a great deal of business and scholarly interest. Dueling papers discuss whether Hedge Fund activism enhances shareholder value or is it simply a way to profit from short term moves at the expense of long term value. [7] Regardless of which point of view one may find persuasive, it seems that the background of these economic and market developments occurring along with political and theoretical developments has pushed corporate purpose to the center of recent corporate governance debates.

BOX 1 – Recent Developments in Several Jurisdictions

- In the UK this can be seen in the rise of "Enlightened Shareholder Value" and its accompanying changes in Section 172 of the Companies Act 2006.
- In India, there are provisions on the Companies Act 2013 that ensconce "stakeholder" theory (section 166 and Schedule IV) and create a requirement to engage in "corporate social responsibility" (section 135) as well as proposals to create 'premium listings' at NSE.
- In the US we have seen major political and industry figures propose changes to Corporate Law to make it more stakeholder centric:
  - i. U.S. Senator Elizabeth Warren proposed the "Accountable" Capitalism Bill 2018 which mandates stakeholder theory, worker representation on the board, and a host of other changes to standard U.S. corporate law. [8]
  - ii. Delaware created a process for certifying firms' activities in the socially responsible space. [9]
  - iii. Delaware allows for "benefit" corporations whose purpose may include things beyond profit maximization. [10]
  - iv. California has proposed a draft bill requiring gender quotas on boards of firms with operations in California. [11]

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7 See, e.g., Lucian A. Bebchuk, Alon Brav, and Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 Columbia Law Review 1085 (2015); K.J. Martijn Cremers and Simone M. Sepe, *The Shareholder Value of Empowered Boards*, 68 Stanford Law Review 67 (2016); Jesse M. Fried, *The Uneasy Case for Favoring Long-Term Shareholders*, 124 Yale Law Journal 1554 (2015); Marcel Kahan and Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 University of Pennsylvania Law Review 1021 (2007); Mark J. Roe, *Stock Market Short-Termism's Impact* (August 13, 2018). Available at SSRN: https://ssrn.com/abstract=3171090.

8 Accountable Capitalism Act, S.3348, 115th Cong. (2018).

9 Delaware Certification of Adoption of Transparency and Sustainability Standards Act, H.B. 310, 149th Gen. Ass. (De. 2018).

10 Del. Gen. Corp. L. § 361; 79 Del. Laws, c. 122, § 8.

11 See David A. Katz & Laura A. McIntosh, *Gender Diversity and Board Quotas*, Harv. L. School F. on Corp. Governance and Fin. Reg., (Jul. 27, 2018), https://corpgov.law.harvard.edu/2016/03/25/gender-diversity-on-boards-the-future-is-almost-here/ (originally published as a memorandum from Wachtell Lipton in the New York Law Journal).

III. Long Term Sustainable Value & Corporate Governance

The recent statements by Mr. Fink and others, noted earlier, on long-term sustainable value (LTSV) and on corporate purpose have sent substantial ripples throughout the corporate governance world. [12] Before examining how firms may respond to LTSV, it is important to define what it means as the phrase leaves much open for interpretation. Fortunately, there has been considerable discussion of LTSV to guide us in understanding the scope of what the asset management firms intend.

A. What does LTSV mean?

First, it appears that this vision of corporate purpose is focused on enhancing the *financial future* for clients of asset management firms via long term sustainable growth, which appears to mean that

> Just as we expect the companies in which we [the asset management firms] invest to understand the macroeconomic and industry trends in which they operate, we also believe that a company's awareness of regulatory and societal trends helps drive long-term performance and mitigate risk. [13]

This suggests that the focus on environmental, social and governance (ESG) considerations is primarily driven by how they are likely to impact financial performance in the longer term via how they impact regulation (which, for example, may impact the penalties the firm may suffer for a violation or what is considered a violation) or how they impact society's views of the firm or industry (which, for example, may impact the firm's reputation or potential markets for its products). The interest in ESG is not simply because ESG considerations are of interest, but because they are likely to impact financial performance at some point. Under this view, LTSV would not lead to enforceable actions by non-shareholder stakeholders against the board or management.

B. What do asset managers expect investee firms to do?

What does LTSV then add to shareholder primacy? It appears to add a great deal in terms of how firms operate. In particular, asset managers relying on LTSV would expect firms to provide a detailed discussion of their longer-term strategy and how they account for ESG considerations impacting financial performance, how they intend to attend to risk management, and how they plan to engage with investors (especially the asset management firms) amongst others. [14] These are critical in the discussions the asset management firms have had thus far. Each one merits some comment.

The asset management firms have repeatedly stated they want the firms in which they invest to explicitly discuss their long-term vision for financial performance and how they think about (and address) long-term economic and societal concerns. This would require having discussions and plans for addressing these concerns in an engaged and vigorous manner (e.g., define a business plan, identify risks, discuss how to address them, and consider options to follow). In other words, generic statements about risks and ESG are unlikely to satisfy the asset management firms. They are interested in specifics about steps firms are taking to address LTSV and what is the reasoning and analyses behind those steps. [15]

As part of examining these concerns, the asset management firms expect firms to address risk management and ethical behavior openly and in detail. [16] This puts a premium on forethought as well as compliance activities. This is likely to involve identifying risk appetites explicitly and how to address likely risks from multiple arenas. Moreover, it may be expected to generate discussions about the role of compliance.

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12 See Fink Letter, Friedman response and Martin Lipton, *The New Paradigm*, HARV. L. SCHOOL F. ON CORP. GOVERNANCE AND FIN. REG., (Jan. 11, 2017), https://corpgov.law.harvard.edu/2017/01/11/corporate-governance-the-new-paradigm/.

13 Novick, Edkins and Clark, BlackRock, July 24, 2018, available at: https://corpgov.law.harvard.edu/2018/07/24/the-investment-stewardship-ecosystem/.

14 See Fink Letter, Friedman response, and Lipton's "New Paradigm".

15 See Fink Letter, Friedman response, and Lipton's "New Paradigm".

16 See Fink Letter, Friedman response, and Lipton's "New Paradigm".

Finally, engagement appears to involve on-going discussion and communication with investors (especially asset management firms). This is thought to be important to secure the support of the asset management firms, should there be an activist investor calling for action or hostile acquisition activity. [17] It is also thought to be important to the more collaborative relationship asset management firms desire with the firms in which they invest. Indeed, Mr. Fink explicitly stated that collaboration with the asset management community is of importance.

If taking these steps (and others) is truly likely to attract the interest and hence capital of these asset management firms, then that could shake up how governance is typically operationalized. However, it would be remiss to think these matters are only of interest to capital providers. There is growing evidence that top talent is also quite concerned about a number of the ESG issues and that firms may wish to consider greater involvement in these areas to retain that talent. [18]

IV. Implications for Indian Corporates

This discussion raises implications for Indian corporates that are either trying to raise capital from asset management firms or who are otherwise trying to navigate the somewhat changing corporate governance terrain. Below are a number of non-exhaustive suggestions, cobbled together from the indications provided by asset managers and parties they often work with, that could be useful to consider. [19]

- Discussion of Long-Term Strategy: The board is expected to describe (a) the corporation's long-term strategic vision and business model using clear and concise language that lays out key risks and opportunities and (b) the steps it intends to take to address them. This will involve getting informed about these matters, informing investors of these matters and engaging in thoughtful discussion of these matters. This long-term vision is to be geared to achieving long term sustainable value for the corporation.

- ESGs and Social Impact: The board is expected to devise appropriate standards for ESG and matters of social import and weave them into long term strategy and regular operations. This could range from standard ESG matters, to regulatory and societal trends, to broader issues of human flourishing amongst others. The key is these considerations should be woven into the strategic direction of the firm and its operational planning to maximize LTSV. Synergies between ESG and regular financial performance should be explicitly addressed and discussed. The exact constellation of matters considered here is likely to vary with the firm and business sector.

- Sustained and Serious Engagement with Shareholders (e.g., Asset Managers): The board is expected to develop methods of communicating with asset managers and to keep sustained and serious engagement with them. This will require interactions with these shareholders to not only understand their concerns, but also collaborate with them in the long term. This may involve both proactive and reactive conversations and greater transparency. However, the communication should not be limited to just investors. The board should consider discussions, where appropriate, with members impacted by the corporation's activities such as other stakeholders. Simply put, there should be on-going communications – designed to facilitate engagement with investors and to learn about the corporation's social "footprint"—which are not just limited to crises.

17 See Fink Letter, Friedman response, and Lipton's "New Paradigm".

18 See Jennifer Thompson, *Asset managers engage in ESG 'war for talent'*, FIN. TIMES, (June 16, 2018), https://www.ft.com/content/0695124e-6eec-11e8-852d-d8b934ff5ffa.

19 See Fink Letter, Lipton's "New Paradigm," and Novick, Edkins and Clark.

- Risk Management & Instilling Ethical Behavior: This requires establishing the firm's risk profile and designing risk management systems to facilitate this. This will also involve inculcating a sense of risk-awareness at the firm and strengthening compliance initiatives and response protocols. Designing such a system will bring investors into closer collaboration with management both in assessing risk and taking steps to manage it. Further, top management should take measures to clearly prioritize integrity and ethical standards to enhance LTSV.

BOX 2 – Practical Measures for Indian Corporates

- Devise Long Term Strategic Plan that addresses both financial and societal concerns.
- Ensure that long-term strategic plan gives explicit consideration to ESG and how it fits with strategic direction or purpose of the firm.
- Plan for communicating and engaging with shareholders not just to hold off hostile activities but also to collaborate with them and learn about the corporation's social "footprint".
- Develop Risk Management Plans and take steps to instill ethical behavior.