2nd Summit on the Future of the Corporation

Hosted by Corporation 20/20

Paper Series on Restoring the Primacy of the Real Economy

JUNE 2009

ALLEN WHITE, EDITOR

New Principles for Corporate Design

1. The purpose of the corporation is to harness private interests to serve the public interest.
2. Corporations shall accrue fair returns for shareholders, but not at the expense of the legitimate interests of other stakeholders.
3. Corporations shall operate sustainably, meeting the needs of the present generation without compromising the ability of future generations to meet their needs.
4. Corporations shall distribute their wealth equitably among those who contribute to wealth creation.
5. Corporations shall be governed in a manner that is participatory, transparent, ethical, and accountable.
6. Corporations shall not infringe on the right of natural persons to govern themselves, nor infringe on other universal human rights.

For information on the development and context of these principles, www.corporation2020.org

JUNE 2009

Dear Colleague:

It is my pleasure to present you with a copy of this Paper Series in conjunction with the 2nd Summit on the Future of the Corporation: Restoring the Primacy of the Real Economy, Boston, June 9-10, 2009.

The Paper Series and Summit mark the fifth anniversary of the launch of Corporation 20/20. The small core group that began this journey, comprising individuals from business, civil society, finance, labor, law and the media has grown into an international network of nearly 400 participants with a shared commitment to rethinking the fundamentals of the modern corporation. Through convenings, e-dialogues and research, Corporation 20/20 has continued to challenge the conventional notions regarding the design of the modern corporation, including its purpose, ownership, control, governance, capitalization and other components of the corporate form.

Few of us involved in this journey could have imagined how relevant our work would be in light of the bubbles, busts and crises that have emerged in recent years. The topic of corporate purpose and structure has shifted from relative obscurity to front page headlines as all stakeholders grapple with the worst economic recession in decades. In particular, the role of the financial sector, a comparatively minor concern of Corporation 20/20 in its early years, has assumed a position of equal standing to the non-financial ("real economy") sector on the agenda of the initiative.

Reflecting this shift, the papers in this document and the 2nd Summit itself pay special attention to the purpose, regulation and restructuring of the financial sector at both the global and national levels. In the spirit of all Corporation 20/20 activities, paper authors challenge us to think "outside the box" and to open our minds to new ways of thinking about the nexus of capital and corporations. There is no issue of greater importance to achieving a just and sustainable economy in the decades ahead.

We offer our sincerest appreciation to all authors for their contributions. Thanks also to the editorial team of David Wood, Faye Camardo and Nina Smolyar, and to Christina Williams for design of this document. We hope participants in the 2nd Summit as well as readers worldwide will find these papers both informative and provocative.

Cordially,

Allen L.White
Director, Corporation 20/20
Senior Fellow, Tellus Institute

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Beyond the Crisis:

Policies to Foster Long-Termism in Financial Markets[1]

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IF A GROUP OF LEADERS WITH DIVERSE perspectives but a common concern for reintroducing long-term orientation in business and markets were to brainstorm about public policy, what kind of recommendations would they make? Since 2004, The Aspen Institute's Corporate Values Strategy Group (CVSG) has been facilitating dialogue among corporations, organized labor and public pensions, with the hope of influencing federal and state policy when the window of opportunity opens. Organized around the pervasive and destructive problem of market short-termism, CVSG aims to promote business and market practices that curb short-termism and refocus the relevant players on creating long-term value for all stakeholders, with special focus on augmenting the voice of long-term oriented investors.[2]

The purpose of this paper is to explore a range of public policy prescriptions that have emerged over dozens of conversations and several years time, at a moment of renewed interest in the regulation of the financial services sector in particular, and business in general.

FOUNDING ASSUMPTIONS

The Aspen CVSG starts from the assumption that corporations represent a vital and influential institution in society. In order for corporations to perform at their best, they commit to endeavors that may take years and, in some industries, decades, in order to realize both societal benefits and to make profits for their financial investors. The unmitigated growth in short-term financial pressures that we have observed over the last several decades can greatly limit this potential to benefit society; indeed, it causes great harm.[3]

A new administration in Washington and unprecedented public attention to business and financial markets offers a unique opportunity for public-policy recommendations in pursuit of long-term wealth creation to gain visibility and, possibly, to obtain real traction.

Given this direct link between the potential of business to create value and the need for long-term perspective, CVSG takes the consequences of short-termism as the point of departure for its deliberations. Short-termism constrains the ability of business to do what it does best—create valuable goods and services, invest in innovation, take prudent risks, develop human capital, and address issues of social and environmental significance. Short-term financial metrics encourage companies to externalize costs on wider society. The internal incentives and market signals that follow from short-termism drive the kind of dysfunctional, value-destroying behavior we have witnessed since the fall of Enron and, on a much grander scale, in the current financial crisis. Short-termism is not limited to the behavior of misguided individuals; it is system-wide, with contributions by and interdependencies among companies, asset owners, asset managers, and government.

ASPEN PRINCIPLES AS THE PLATFORM

The Aspen Principles on Long-Term Value Creation, released to the public in June 2007, served as a starting place for this dialogue on public policy. Drafted under the leadership of CVSG members including senior-level representatives from business, corporate governance, public pensions, and organized labor, the Principles represent a consensus of "strange bedfellows" on actions that are aimed at counteracting short-term focus at the company level, and that may have broader ripple effects throughout the wider market. The Principles urge companies to define firm-specific metrics of long-term value, and then use these metrics both to communicate with investors around long-term measures and activities, and to better align executive compensation with the creation of long-term value.[4]

Voluntary actions undertaken by individual companies and boards are an excellent starting place to make positive changes in the market. But even before the economic crisis became front-page news, it became clear that in order to succeed in influencing the behavior of business and markets on a wide scale, the principles of practice for long-term orientation must be bolstered by system-wide incentives; that is, mandates and rules that comprise an integrated redesign of financial markets regulation.

APPROACH TO DIALOGUE

As Election Day 2008 approached, participants in the CVSG acknowledged the potential for public-policy discussion aligned with the work on curbing short-termism. A working group convened around the following assumptions and operating principles:

Focus on the system and not just the corporation, recognizing that a "complex dance," involving both companies and investors, drives the results we have now.

Work toward developing a coherent package of ideas rather than a piecemeal approach, and embrace all links in the investment chain.

Seek the common ground among different market actors with an interest in extending time horizons in the business system, with the hope of creating a common platform.

As a result, rather than start the policy discussion with a re-examination of the corporation and its purpose, the focus of the dialogue was to work with individuals and influential organizations who were deeply concerned with the consequences of short-term thinking and acting, and who thought change possible. This included people who were closely engaged with our work on short-termism and, thus, enjoyed a degree of mutual trust, forged through the development of the Aspen Principles of practice. We also included participants who had a Washington insider's perspective on what was possible in the political sphere. In a search for common ground, we began from the assumption that all input to the dialogue process was useful, regardless of political viewpoint or role.[5]

THE BETTER SYSTEM: 2015

- Appropriate and trusted balance between and alignment among government, business, investors, and society at large.
- Greater understanding of how the different participants in the market (e.g., business, investors, and policy) relate to the system; and greater lines of sight regarding consequences of decisions and behavior.
- Businesses with clarity of purpose, focusing on delivering excellent goods and services, and creating sustainable long-term value.
- Transparency on issues that matter–businesses providing information that offers appropriate insight into past performance, compensation and incentives, and indicators of future health.
- Better sharing of wealth, based on more equitable evaluation of contributions.
- Public policy characterized by an appropriate balance between short-term and long-term business and investment incentives.
- Business leaders actively engaged in addressing long-term societal challenges that affect the business environment.

PRINCIPAL GOALS

The ideas we present below were developed through a series of five meetings held between mid-2008 and March 2009, and have roots in conversation that began two years prior.[6]

The June 2006 CVSG summit was based around the idea of envisioning a better system by the year 2015; participants identified characteristics of capital markets in which a better balance between short- and long-term horizons is achieved. (See box, "The Better System: 2015" at right.)

The recommendations that emerged from this visioning process largely prefigured those that would eventually comprise The Aspen Principles, released in June 2007.

In July 2008, CVSG defined its policy discussion goal as follows: "Identify and test constructs that provide an approach to policy action that creates a more supportive environment for companies and investors concerned with creating long-term value that is in the interest of the common good."

Compared to two years prior, the July 2008 summit focused specifically on how public policy could encourage long-term oriented business and investor behavior. Recommendations centered around five goals, with accompanying suggestions about how those goals might be accomplished:

Encourage more patient capital and discourage investor churning: For example, institute minimum holding or vesting periods as a prerequisite to the exercise of certain shareholder rights; change capital gains and tax policy to reward long-term investment; and develop new long-term investment products with restricted access to invested capital for individual investors in retirement and other long-term contributory schemes. Discussants called for additional research by experts to test these ideas.

Promote greater investor transparency: For example, require more and better disclosure of holdings by investors, intermediaries, and agents on record dates and when acquiring significant positions (short and long) in order to illuminate conflicts, discourage "empty" voting, and enable operating companies working to amplify the voice of long-term holders to know who owns their shares, and in what quantities.

Hold financial intermediaries to a higher degree of accountability: Increase disclosures on compensation, incentives, trading, and other such matters that would indicate compatibility, or lack thereof, with the stated goals of the *ultimate* investors, such as pensioners and those saving for college.

Encourage corporate use of compensation and incentives that better align employee interests with the long-term health of the company: For example, modify tax treatment of options and tax rules on the deductibility of executive compensation as a corporate expense.

De-emphasize the quarter: Refocus managers on long-term value creation and productive activity by encouraging the release of broader performance metrics and strategies as a target for management discussion, and move the statutory requirement for U.S. company filings from quarterly to semi-annually, as is done in other countries.

In October 2008, we began to facilitate a small working group interested in public-policy ideas and representative of diverse perspectives and organizational affiliations. The following criteria were applied to the search for the best ideas, and in order to triage a longer list of proposals presented for consideration by this small group:

- What is mission critical versus less critical (higher versus lower priority)?
- What is less controversial/easier to do (technically, politically) versus more controversial/ difficult to achieve?
- Are there any logical linkages between ideas?

Four of the five policy goals outlined during CVSG's July 2008 summit ultimately were reflected in the final set of "building blocks" developed by this working group that focused on policy outcomes from October 2008-March 2009.[7] The policy discussion and subsequent ideas (see Appendix) were significantly clarified and galvanized by the growing financial and economic crisis. While the headlines have remained similar from July 2008 to now, what changed was an articulation of how the policy goals would be achieved—more specifics were included in some areas and a change in scope modified other goals. Two new areas for policy focus were discussed and were added to the mix: (1) the role of excessive risk-taking; and (2) the role of leverage in the current economic crisis.

The building blocks outlined below represent concepts that participants believed were critical to restoring trust and confidence in financial markets, the foundation of any sustainable recovery.[8] They believed these concepts are also necessary to move the U.S. toward a smarter financial system, one that is focused on long-term societal health, not just until the next bonus is banked. These building blocks are supported by specific examples of actions (to be implemented by the U.S. government, state governments, and stock exchanges), some of which are described in the next section and in the Appendix.

Create revenue and pricing incentives to encourage more patient capital and discourage investor churning. In collaboration with other OECD countries, the U.S. should develop tax-based mechanisms with a market-wide reach to encourage investors to hold stock over longer periods. These could include a trading tax to discourage churning, changes in the capital gains tax to re-define "long term" and to reinstate Clinton-era rates on holdings of between one and five years, and end the "2 and 20" loophole that allows fund managers to claim capital gains tax treatment for their cut of the carried interest of their investors, thus avoiding paying income tax.

Strengthen investor disclosures to promote greater transparency about who owns what. The current economic crisis has shown that a number of actors whose roles in the market have far-reaching effects have been flying under the radar of existing reporting and disclosure requirements, often obscuring potential interests and motivations. Greater disclosure about these entities' transactions will lead to a clarification of their roles in the market. This may be achieved by requiring more and better disclosure of holdings by investors, intermediaries, and agents on record dates and when acquiring significant positions (short, long, and derivatives) in order to illuminate conflicts and to enable operating companies, focused on the long-term, to know who owns their shares, and in what quantities. In addition, pension funds should be required to disclose their share-lending policies and all should be banned from voting by use of borrowed shares.

Hold financial intermediaries to a higher degree of accountability—ensuring their interests are aligned with their ultimate investor—by requiring increased disclosures on compensation, incentives, trading and other such matters that would indicate compatibility, or lack thereof, with the stated goals of the ultimate investors. In many ways, financial intermediaries, such as asset managers and portfolio managers, have become divorced from the interests of those who provided the capital in the first place; these ultimate investors are often investing for long-term goals such as college and retirement, while the intermediaries manage this money with a quarterly or annual horizon. As such, financial intermediaries should be held to a higher level of fiduciary duty, taking greater care in their role as agents and acting in ways that are beneficial to the ultimate investor. Through creation of new or clarification of existing federal laws or regulations, the following might be required:

- Compensate the managers of long-term oriented, tax-advantaged funds, such as 401 (k) and college savings (a.k.a. LT funds), based upon the fund's long-term performance.
- Extend to mutual funds the compensation disclosure requirements that are currently applicable to operating companies.
- Ensure that LT fund and index fund managers are taking fundamental risk into account when they invest their clients' funds, and are voicing concerns and engaging in activism about risk in stocks within their portfolios assuming they cannot sell.
- Ensure that LT fund managers vote and invest in ways that will promote prudent growth and that index fund managers also vote their shares in a manner that reflects the long-term orientation and actual holdings of the portfolio.
- Ensure that LT fund managers disclose and explain excessive annual portfolio turnover.
- Require public disclosure of proxy advisors' criteria for making voting recommendations to mutual and pension funds, and prohibit pension, college savings, index, or 401(k) funds from relying on a proxy advisory service for voting advice unless that service gave voting advice based on the perspective of a long-term investor in the corporate issuer.
- Require public disclosure of the revenues proxy advisors receive from public companies and institutional investors, and the nature of the work that generates those revenues.

De-emphasize the focus on the next quarter and refocus managers on long-term value creation and productive activity by requiring that quarterly guidance may be given only in the context of a clear long-term growth plan. In the past, the SEC has deemed information misleading when it is not placed in appropriate context. Only if short-term guidance is actually placed within this larger context is it meaningful to a long-term investor, and even then it is of minimal utility to investors who are invested for 10 to 15 years or longer.

Better focus corporations on real risk and opportunity. To create a corporate culture where greater attention is paid to the real risks and opportunities facing the company, corporations should assign explicit responsibility for such risk management to their boards and senior-level staff; specific changes might be mandated through new or revised federal legislation, regulation, or stock exchange rules. Boards should be encouraged to create a committee specifically focused on non-accounting risk, and to rethink their operating models to set aside necessary time to devote to strategic planning, management oversight, and compliance. Policymakers should consider building on Sarbanes-Oxley requirements to mandate certification of companies' risk management processes by top executives and an outside auditor.

Limit opportunities for excessive risk-taking that can translate into extensive value destruction. The current economic crisis shows the widespread destructive effects that can result from investors' efforts to make short-term profits through excessive risk-taking or leverage. While these actions may make profits for a handful of firms and individuals, they may ultimately inhibit real economic growth. These speculative practices may give clout to short-timers with interests often adverse to long-term investors, and may create excess volatility and risk in the equity markets. Following are some actions that might begin to remedy the current situation (see Appendix for additional ideas):

- Implement a leverage limit that should include, at a minimum, investment funds subject to the Investment Company Act of 1940 and any hedge fund that accepts investments from pension funds, states, counties or other municipalities, and universities.
- Regulate hedge funds as financial intermediaries. Up to 70% of securities trading is conducted through hedge funds whose actions are not regulated; therefore, hedge funds should be regulated and particular focus should be placed on their approach to risk, their use of leverage, and their potential conflicts of interest.
- Increase the reporting threshold for off-balance-sheet entities.

OFF THE TABLE BUT NOT FORGOTTEN

The policy discussions we facilitated began with many wide-ranging ideas that were gradually winnowed down to those encompassed by the "building blocks" described above. Participants in the discussion prodded each other to think big, while simultaneously remaining aware of the little things that could improve matters incrementally.

Nevertheless, there were several ideas that dialogue participants considered, but which failed to move forward due to insufficient support. These ideas may be relevant to those who are interested in creating a more just and sustainable world, and for this reason we share these ideas, in particular, and with greater specificity in the following pages.[9]

To address the goals of more patient capital and better investor transparency, two additional ideas emerged:

Reform the use of rule 14a-8 to strike a balance more useful to long-term shareholders

- **The current challenge**: Rule 14a-8 in the Securities Exchange Act of 1934 has produced stockholder activism that is beneficial to investors.[10] Nevertheless, the volume of activism also has substantial costs: while filers bear a small filing cost, the number of proposals has mushroomed, increasing the time that management devotes to proposals (and not to managing the company). In addition, these proposals may be brought by people who have not owned company stock for any period of time, who only own a very small stake, and/or may be net short the company. At the same time, the SEC has kept Rule 14a-8 from being a tool for investors to have a stronger voice and to be able to address, on a company-by-company basis, issues such as proxy access.
- **The proposed changes**: The changes described below would allow shareholders concerned about a company's social and environmental practices to register their concerns with relative ease, but would keep short-term investors and/or those with short positions from impacting company behavior through the proxy process.
  - Leave in place the current low thresholds for social proposals dealing with issues such as the environment, labor, and human rights, but require that the proponent have owned shares at least a year.

- Raise the eligibility criteria for using Rule 14a-8 to submit non-social proposals by requiring that proponents hold a significant, net long stake for at least a year before making a proposal and establish a reasonable filing fee for submitting non-social proposals.

In order to address the concerns expressed by shareholders of all sizes about their inability to meaningfully push back against a board and its management when actions are taken which are contrary to the wishes of the shareholders:

- Eliminate the exclusion that keeps election reform proposals from being presented under Rule 14a-8 [Rule 14a-8(i)(8)]. This would promote a private ordering solution to issues like proxy access, "majority voting," and electoral expense reimbursement.
- In addition, states like Delaware should pass a statute, clarifying that bylaws allowing for reimbursement of proxy expenses, proxy access, and non-binding votes on executive compensation ("say on pay") are valid. States might require a form of proxy access and expense reimbursement annually at companies with classified boards and every three years for board slates receiving more than 30% of votes.

Permit corporations to grant shareholder voting and rights based on duration of holding

- **The current challenge**: Shareholders who propose long-lasting corporate governance changes or other fundamental alterations in business strategy should have a substantial, long-term interest that signals their motivation in wanting the corporation to prosper over the long haul. Currently, this is not the case. One way of ensuring this is to allow only true "owners" of stock, and not transient "renters," to have a substantive voice in a company.
- **The proposed changes**: Through a state law modification, corporations could grant voting and other rights through changes in their corporate charter. For example, corporations could give more weight to the votes of long-term equity holders. In the same vein, corporations could grant certain rights, such as the right to present a bylaw or seek books and records, to equity holders based on how long they have owned shares, and require those exercising certain rights to have a net long position.

To address the goal of focusing corporations more on the long-term creation of wealth and real risks and opportunities, two additional disclosure-related ideas were proposed. Shareholders are not granted the protections of the corporation as a societal aim, in and of itself. Limited liability encourages shareholders to hand over their capital to corporations, which will engage in risky, but possibly profitable ventures. The desired, aggregate outcome of this corporate risk-taking is the generation of financial profits and an increase in societal wealth. In the process of generating financial profits, corporations have multiple incentives to employ and train workers, to develop innovative products and services, and to engage in other activities that increase—not diminish—societal wealth. One might expect to find an accounting of a company's contribution to society in its voluntary ESG or CSR report; nevertheless, such reporting is voluntary and is limited in comparability even by those using the Global Reporting Initiative's G3 framework.[11]

Improve corporate compensation disclosure with context on societal impact

- **The current challenge**: Over the last 25 years, executive compensation has grown significantly, while the real income growth of the average U.S. worker has stagnated. The SEC has a rather new Compensation and Disclosure requirement; nevertheless, this requirement focuses only on the top executives and provides no context.
- **The proposed change**: To give the public a better sense of companies' impact on society via their workers, corporations should be required to disclose information about the growth in pay and benefits to top executives over time in comparison to the median wage and benefits package paid to other employees in the company. Other useful information might include the size of the corporation's workforce; a breakdown of full-time, part-time, and temporary employees; the percentage of employees provided with health insur-

ance; and a breakdown, by country, of the number of workers and revenues where a company operates.

Mandate key disclosures on environmental and social issues

- **The current challenge**: A corporation is not merely an instrument of private wealth creation; thus the public has a vested interest in the way in which such wealth is created. However, little disclosure is expected of U.S.-based or traded companies on the human impact of their operations, beyond specifics such as release of air pollutants. Some European nations are now requiring corporations to make comprehensive disclosures about the effect their policies have on the nation, such as the environmental impact of their operations. One might expect some of these data points to be included in a company's ESG or CSR report; however, the disclosure is voluntary.
- **The proposed change**: Require publicly traded corporations in the U.S. to disclose information regarding their environmental and labor practices. This would give the public and shareholders alike a better understanding of companies' real human impacts, and its effects on the environment. It would also help policymakers identify industry participants who are externalizing costs to competitors or society at large, and policy areas where further regulation is needed.[12]

REFLECTIONS

Our role in the ongoing dialogue has been one of secretariat, facilitator, and process cheerleader. The ideas shared above were not developed by us. They emerged in multiple meetings and have varying degrees of currency among participants; although there is no consensus, and in the current environment of crisis and public distrust said consensus is increasingly hard to achieve. Given this opportunity offered by Corporation 20/20, we thought we would advance two policy-related ideas that have <u>not</u> been voiced in any forum we've organized.

First, if companies are to focus on creating and sustaining value into the long term and fully account for their societal impacts, policy actions must look clearly and boldly at redefining fiduciary duty from a shareholder-centric orientation to broader, multi-stakeholder orientation. Companies that manage to a single, financial objective will continue to miss important risks and fail to capture important opportunities to bring the talent of business to bear on problems that matter.

A sustainable company must be one that not only achieves longevity, but longevity by virtue of its attentiveness to the legitimate interests of those who both influence and are influenced by its decisions and investments. In this vein, one policy idea is to redefine the "license to operate" through a corporate charter that must be renewed every 20 or so years. The renewal process would include multiple voices answering such questions as: 1) Is the company producing useful, valuable products and services?; 2) Is the company a good employer?; 3) Is the company a good neighbor to its local community?; and 4) Is the company a good corporate citizen in the eyes of government?

Second, more research is needed to understand the corporate structures of companies that have succeeded at long-term focus. Though not a new public policy prescription, we believe that state laws already may offer sufficient opportunity to structure ownership, control, and voting rights in ways that could advantage long-term orientation; yet, those examples are not well understood. Many advocates and academics are interested in new forms of corporate structure such as the For Benefit Corporation ("B Corp") discussed in complementary initiatives; it would be useful to build knowledge of commonplace voting and ownership structures that advantage a long-term view, and that can be accomplished under existing law.[13]

The process we have been facilitating strives to offer a new vision for policy and regulation which will vastly diminish the forces of short-termism and drive behaviors that refocus on the long term. We hope that these ideas—those that "survived" the autumn 2008-spring 2009 facilitation process, those that were discarded, and new ideas we suggest above—can play a constructive role in the valuable dialogue on corporate design that Corporation 20/20 continues to facilitate. ■

APPENDIX: SUMMARY TABLE OF PUBLIC POLICY IDEAS

IDEA	MODE OF ACTION: Federal Legislation	Federal Regulation	State Law Action	Exchange Rules	Clarify Existing Rules
Still on the Table for Discussion					
Implement a trading tax	X*				
Modify capital gains rates	X*				
End the "2 and 20" loophole	X*	X*			
Enforcement of fiduciary duty of fund managers to take into account fundamental risk when investing					X
Extend the compensation disclosure principles to mutual funds	X	X			
Create accountability on the part of proxy advisors	X	X			
Special rules for LT tax favored investments [college savings, 401(k)]	X	X			
Special voting rules for index funds	X	X			X
Enhance & make more timely the disclosure of economic interests of activist investors	X	X			
Limit leverage by funds/regulate hedge funds	X	X			
Ban voting of borrowed shares	X	X	X		
Require investment funds to disclose share lending policies	X	X			
Limit certain rights to long-term, net holders	X	X			
Consider requiring issuers to disclose and update a long-term plan for the growth of corporate earnings if they wish to give quarterly earnings guidance	X	X			
Consider requiring that boards have a separate risk management committee to address non-accounting risks				X	
Give boards more time to focus on the company's business plan, the oversight of management and its performance, and the management of risk	X	X			
Consider requiring that an officer-level risk management process be the subject of certifications by the CEO, chief legal and financial officers, and outside auditor	X	X			
Increase reporting threshold for Off-Balance Sheet Entities	X*	X			
Permanently reinstate the uptick rule and outlaw naked short-selling	X*				
Institute leverage limits and reinstate sensible margin limitations for financial institutions & investment funds	X*	X			
Regulate credit default swaps as securities	X*	X			
Impose capital and disclosure requirements on all parties writing credit insurance contracts and credit default swaps	X*	X			
Off the Table but Not Forgotten					
Reform the use of Rule 14a-8 to strike a balance more favorable to genuine, long-term investors			X		
Clarify that long-term investors may pass bypass laws requiring reimbursement of proxy expenses, proxy access, and a non-binding vote on executive compensation			X		
Improve disclosure of executive compensation by placing it in the context of other corporate policies and their effects on other corporate constituencies and societal interests	X	X			
Require corporations to disclose information regarding their environmental, labor, ethical, and worker safety practices	X	X			

** International coordination would be highly desirable*

ENDNOTES

1 We wish to acknowledge David Langstaff, Damon Silvers, and Leo Strine, Jr. for their energy and intellectual contributions that shaped many of the ideas presented in this paper. Any error in representation is inadvertent, but it is ours.

2 CVSG is a program of the Aspen Institute Business and Society Program (Aspen BSP), which is dedicated to developing leaders for a sustainable global society. Aspen BSP engages with business leaders and business educators alike to help create a new vision of business that incorporates stewardship of the environment and society.

3 CVSG's focus on short-termism is rooted in the work of The Conference Board's Blue Ribbon Commission on Public Trust & Private Enterprise, formed in response to the fall of Enron. More at: http://www.conference-board.org/knowledge/governCommission.cfm

4 Aspen Institute Business & Society Program, "Guiding Principles for Long-Term Value Creation," June 2007. Accessible at: http://www.aspeninstitute.org/sites/default/files/content/docs/pubs/Aspen_Principles_with_signers_April_09.pdf

5 The focus of the CVSG and policy dialogue has tended to avoid fundamental rethinking of the purpose of the firm; however, Aspen BSP believes that these fundamental questions are timely and relevant. Over the last decade, and more recently through our Center for Business Education, we have convened and supported the work of dozens of academics and others pursuing significant change in theory and business practice in pursuit of business' contribution to society and sustainability.

6 A list of participants for the June 2006 and July 2008 summits can be found on http://www.aspeninstitute.org/policy-work/business-society/corporate-programs/corporate-values-strategy-group/participant-list

7 Others expressing their opinions in mainstream publications in recent months have called attention to the many policy goals and related ideas, including compensation and quarterly reporting that were articulated during the July 2008 summit.

8 Aspen CVSG public policy working group papers, December 2008-March 2009.

9 Aspen CVSG public policy working group papers, December 2008 and February 2009.

10 What is rule 14a-8? Per the SEC: "Rule 14a-8 provides an opportunity for a shareholder owning a relatively small amount of a company's securities to have his or her proposal placed alongside management's proposals in that company's proxy materials for presentation to a vote at an annual or special meeting of shareholders. It has become increasingly popular because it provides an avenue for communication between shareholders and companies, as well as among shareholders themselves. The rule generally requires the company to include the proposal unless the shareholder has not complied with the rule's procedural requirements or the proposal falls within one of the 13 substantive bases for exclusion." Accessed 26 March 2009 from: http://sec.gov/interps/legal/cfslb14.htm

11 Developments in various countries suggest that mandatory reporting is gradually emerging and may become far more common than it is today. For example: Sweden has mandated GRI reporting for state enterprises. Denmark mandates CSR information in the annual reports of 1100 largest companies. The Johannesburg Stock Exchange requires listed companies to comply with the King III Report on Corporate Governance which includes sustainability reporting a key component of good governance. And China encourages state-owned companies to report on CSR activities.

12 See COST-US (Consultation on Sustainability and Transparency), a network of practitioners and academics advocating a major enhancement of non-financial disclosure in U.S. financial markets. http://groups.google.com/group/cost-us/subscribe?note=1

13 A teaching module, "What the Law Allows," is available from Aspen's CasePlace.org. http://www.caseplace.org/d.asp?d=2811 (CasePlace.org registration is required to access this module, but registration is free.)

Toward a Bretton Woods II:

Aligning a New Global Financial Architecture with Sustainable Development

PAUL R. EPSTEIN
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THEY SAY THERE ARE NO ATHEISTS IN A foxhole; it seems there are no 'free market' fundamentalists in a recession. Yet, amidst the most severe economic crisis since the Great Depression, we are clinging to market forces to bring about a recovery. Meanwhile, the world faces escalating climate, food, and water crises. A perfect storm on the one hand; a rare opportunity for integrated interventions and systemic change on the other.

On November 15, 2008 the leaders of 20 nations met in Washington, D.C., to address the international financial crisis. France's President Sarkozy has called for another summit soon, and the 20 nations met in April 2009, with the Obama administration in place.

With the financial collapse and rapidly devolving worldwide economy, calls for a new Bretton Woods Agreement are becoming audible. So much has happened in such a short time, the sense of urgency to restructure global finance has never been greater.

First, the financial mess: the abrupt evaporation of liquidity and lines of credit that has reverberated across the globe. It wasn't hard to see it coming, as 'exotic derivatives'—speculative 'side-bets' on highly-leveraged, bundled stocks and bonds and swaps—rose from $900 billion in 2001 to $45.5 trillion in 2007! (World output—global GDP or *real* wealth—is ~$40 trillion.) The *paper* money was lost in a game of limitless risk transfer; "securitization" that turned out to be anything but.

With some wagering the bundles would fall 'short' and others betting stocks and bonds and currencies would rise, we may come to view this as one grand Ponzi scheme (decentralized and unwitting, perhaps, save for the predatory lenders) that has left a trail of hardships, foreclosures, bankruptcies, layoffs and—the worst—the near collapse of whole economies such as Iceland, Ireland, and Spain. In the U.S., with housing values dropping and Detroit in its self-made sorry state, two major pillars of the U.S. economy have witnessed a precipitous decline in output and market capitalization.

Today's financial market disruption is mirrored by mounting climate instability and accelerating melt of the Earth's ice cover. Meanwhile, plateauing crop yields and economic sinkholes threaten to drag asunder a growing list of nation states. Sometime soon, the disharmonic convergence of economic, energy, environmental, and political instabilities will drive us into a new world order. The mantras of the Washington Consensus—deregulation, liberalization, privatization—led us inexorably into the 2008 downward spiral, the end of an era of seemingly endless but ultimately unsustainable growth. We need a vision for the financial architecture and mechanisms that drive less and very different patterns of consumption.

The old rules of engagement are inadequate for the task we face. We need a new set of regulations, performance and efficiency standards that oblige the economy, once primed, to move steadily in the right direction. Complementing the stimuli needed for developed nations, UN Secretary General Ban Ki-moon, this winter called upon the G20 to establish a $1 trillion fund to help developing nations deal with the contraction in global investments and cope with the social, environmental and political fall-out. But realigning rules and rewards is not sufficient: we also need an institution to administer the funds and assure compliance with a new standards regime. A look back at the evolution of the extant financial architecture is instructive in relation to charting the pathway forward toward meeting the great sustainability challenges of the 21st century.

A BRIEF HISTORY OF WORLD ORDERS

Conscious international efforts to reorder rules of engagement have often followed periods of social turbulence, pandemics, revolutions, depressions, and wars. In the late 18th and early 19th century, revolutions against the old order exploded in the Americas and France, and back to the Americas. After his defeat in Haiti (which led to his capitulation of American territory with the Louisiana Purchase in 1803), Napoleon marched across Europe and his ultimate defeat there led to the momentous Vienna Peace Conference of 1814. And while international relations continued to be dominated by colonial pursuits, and internal conflicts between labor and business caught fire, the 1815 Treaty of Vienna marked the beginning of prolonged peace among European nations.

By mid-19th century, urban crowding (the population of London rose sevenfold from 1790 to 1850) overwhelmed water and sanitation systems. In the 1830s outbreaks of cholera, tuberculosis, and smallpox in London, New York and Boston (and many other industrializing cities) affected city dwellers and sparked protests and revolutionary involvements demanding change. Public health jumped to center stage in national development agendas during this period, and the resulting sanitary and environmental reforms had stemmed the tide of the infections by the 1870s, years before Robert Koch (1883) and Louis Pasteur (1890s) isolated bacteria. While no concerted international developmental effort emerged during this period, the first international funds to coordinate communications were established to support the International Telegraph Union (1865) and the Universal Postal System (1874).

The next turning point came in 1884, when colonial powers met in Berlin to consolidate a new world order. After centuries of extracting gold, ivory, and slaves, colonial powers divided Africa into new dominions. During the subsequent decades, primary accumulation (derived from colonies) and concentration of wealth were accompanied by large migrations, populist and labor movements, a failed revolution in 1905, the First World War, the Russian Revolution of 1917, and the 1919 pandemic of influenza (killing an estimated 20 to 100 million), which together precipitated another attempt to restructure international relations.

The victorious powers from World War I—led by the U.S., U.K., and France (Woodrow Wilson, Lloyd George, and Georges Clemenceau)—met in Paris for a peace conference in January 1919 that would last until June. The Treaty of Versailles and the League of Nations (following Wilson's "Fourteen Points" and principles of "self-determination") kindled new hopes for a new order and a lasting peace.

But many critical problems were left unsolved. Women's participation and women's suffrage were rejected, reparations were exacted from the vanquished, and colonies were reshuffled into League of Nation "mandates." Without funds to reignite the global economy, it took six years for Europe to recover, and the cinders of future conflict smoldered. Rapid, uncoordinated growth led to spirals of speculation and, following the 1929 stock market crash, the Bank for International Settlements (established in 1930) served as a hint of what was to come following the Great Depression and yet another world war, more devastating than the first.

BRETTON WOODS

In the summer of 1944, as the second of two devastating world wars, interspersed by the roaring '20s and Great Depression of the 30s, drew to a close, Western leaders met at the White Mountain resort in Bretton Woods, New Hampshire to form a new world order. The old one was broke and broken. John Maynard Keynes—a Lord, a financial market trader (Bloomsbury group member with Virginia Woolf and Lytton Strachey, among others) and designer of the Lend Lease Agreement (by which the U.S. supported Great Britain in WWII)—was the designated chair. Keynes' 1936 salient book had pointed towards a Third Way of development, combining full employment and a market economy.

Keynes figured out that you didn't have to figure it all out: you had to change the rules that shape the system. The rules shape the body—the morphology of the global economy—and changes in it emerge from changing the underlying rules.

At Bretton Woods, western nations agreed to three rules: 1. free trade in goods, but 2. fixed exchange rates, and 3. constraints on the international flow of capital. (The third of these, whose violation in today's capital markets can only be described as "over-the-top," followed Adam Smith's admonition that healthy competition and comparative advantage among nations would not hold if capital flowed freely and speculatively across borders.)

Soon after, economic stimuli came in the form of the Marshall Plan for European reconstruction and, in the U.S., the GI Bill (priming housing, jobs, schools, and industries). And the international framework to ensure stability was housed in the newly-formed World Bank, the International Monetary Fund, and what was to become the World Trade Organization (WTO).

THE WTO

The WTO, an international organization that deals with the rules of trade among nations, was established in 1995 to replace the General Agreement on Tariffs and Trade (GATT). It extended trade policy from goods to service industries through the General Agreement on Trade in Services (GATS). The WTO was formed to ensure that international trade "flows as smoothly, predictably and freely as possible" and to "help producers of goods and services, exporters, and importers conduct their business."

Unlike the GATT, the WTO is backed by a dispute settlement mechanism, or trade court, and compliance, based on the court's findings, is mandatory for member governments. Through the court, the WTO acts as an arbiter when members' non-trade objectives conflict with their free-trade undertakings.

The effectiveness of the WTO has been questioned by some, and the impacts of its policies on those most in need roundly attacked by others. The WTO has provided the umbrella for huge agricultural subsidies in developed nations, while disallowing protective tariffs. The combination —swords allowed, but shields denied—has undermined and, in many cases, eliminated profitable agriculture in many developing nations.

This complimentary combination of a) sticks, b) carrots, and c) institutional infrastructure catapulted the post-war recovery into several decades of prosperity for some. In that post-war period, the Universal Declaration of Human Rights, framed by Eleanor Roosevelt, was signed, and the United Nations was born out of the ashes of Wilson's League of Nations.

It was truly a time of conscious transformation of world values and the world order—new institutions followed a recognition that the destiny of the world's nations and peoples were inextricably linked and that new governance mechanisms must be put in place to both foster shared, core values as well as to manage a globalizing economy.

A major detour from this evolution occurred in 1971. With U.S. debt mounting from Vietnam War expenditures, President Nixon abandoned the Bretton Woods rules. Free trade in goods was now matched by unhinged exchange rates and deregulation of the international flow of investment capital.

The upward spirals soon began. In the 1970s gold jumped from $38 an ounce to $300 (to >$900 today); oil rose ten-fold, from $3 to $30 a barrel; and nations went hat-in-hand to the World Bank to borrow money to fuel their economies. By 1983, money flowing out of the developing world surpassed that entering in aid and investment, and the debt crisis was born.

By the end of the 1980s, unheard of interest rates (18-19%) drove money into British banks and away from their productive economy, creating a wedge between finance and industry. (This was corrected in the early '90s with a transfer in Great Britain from finance into industry—and the British economy rebounded.) But the '90s saw the unbridled transfer of speculative, 'hot money' (e.g., moving quickly in and out of one Asian capital to another, not stopping to invest in long-term projects). Currency transactions also skyrocketed. In 1972, they amounted to $16 billion daily. Today they are close to $2 trillion per day And today we witness the cliff over which the runaway split between the interests of finance and industry have carried us.

TOWARD A BRETTON WOODS II

If global institutions are to be reconstructed to support inclusive, equitable, and sustainable development, the deliberations must bring all nations to the table (not just 20 chosen ones). And on the table are the rules (the "sticks"), the financial incentives (the "carrots"), and the international financial institutions: The World Bank, the IMF and—of utmost importance—the WTO. A new institution may be necessary—the Global Environmental Facility is one possible model, being a granting (not a banking and lending) agency, and includes the United Nations (UNEP and the UNDP). The GEF, which remains financially tethered to the World Bank, must be democratized.

A new global compact must realign the monetary rules, the regulations, and rewards that determine the shape of the global economy in a way that aligns with the higher purpose of sustainable development. We will need a substantial fund to prime the recovery, spark manufacture and international trade in new technologies and practices, and transform the international finance institutions into bodies with a new ethical foundation and new values that position finance into its appropriate role as servant to the higher purpose of building a sustainable future.

A NEW FINANCIAL ARCHITECTURE

In addressing a framework for a new 21st Century global financial architecture, we can divide the components of financial architecture into three sets: rules, incentives, and institutions.

Rules. New rules are needed to constrain capital flows a) in order to prevent the volatile, destabilizing, speculative movement of capital *and* b) to direct funds towards healthy development.

Debt is the means by which some nations exert control over others. Unpayable debts must be forgiven. Debt forgiveness would be a compensation for past inequities driven by unequal terms of trade and centuries of wealth extraction. For example, debt-driven timber extraction and land clearing for monocultures and biofuels will overwhelm even well-funded measures for forest preservation.

But debt would re-accumulate rapidly unless the conditions that gave rise to it are also changed. The most challenging issue is, thus, the terms of trade (TOTs): the difference between the prices poor nations receive for their exports (e.g., food) vs. the prices they pay for imports (e.g., tractors). Since the 1960s TOTs have steadily widened. Equalizing TOTs is most challenging because it means distributing global wealth more equitably. TOTs must become more balanced, even from a Western, self-enlightened perspective, to maintain purchasing power and global markets. Equity is a prerequisite for trade in goods that is free and fair, and for addressing international divisions among workers.

Incentives and Funds. Perverse subsidies—such as those encouraging deforestation and the extraction, mining, refining and combustion of coal and oil—must be eliminated. Subsidies and tax incentives must be switched to stimulate producers and consumers of clean energy and energy-efficient technologies. New enterprises for solar, wind, geothermal, and other renewables will generate jobs, enterprises, and trade.

International agreements—such as the Kyoto Protocol and the (pending) Copenhagen Agreement, and the Biodiversity Convention—are hindered by the lack of adequate financial resources. Instructive is the universal acceptance of the 1987 Montreal Protocol to phase out stratospheric ozone-depleting chemicals which was achieved when funds were allocated to technology transfer to poor nations (China, primarily; at the time poor). Funds are needed to "jump-start" clean, infant industries and to sustain them in developed and developing nations.

A vast scaling up of funds is needed to support stewardship of what the private sector will not protect—forests, wetlands, watersheds, climate stability—in the face of the short-termism and relentless cost competition associated with a globalized economy.

Potential sources for such Global Fund for Adaptation, for the program for Reduced Emissions from Deforestation and Degradation, and Mitigation include taxes on carbon, airline traffic, and Internet "cyberdollars." A tax on currency transactions—the "Tobin Tax" named after the Noble-prize winning Yale economist, James Tobin—delivers a "two-fer": it would a) dampen the destabilizing influence of "hot money" transfers *and* b) generate significant funds for stewardship of both non-renewable and renewable resources. A quarter of a cent levy on each of the $1.9 trillion traded daily—far less than one pays a broker to buy stocks—would not discourage long-term investments while yielding hundreds of billions of dollars annually.

Institutions. Formed in an era when resources were seemingly infinite and modern environmentalism had yet to take shape, existing international financial institutions are inadequate to the tasks we face today.

A look at the Global Environmental Facility provides some guidelines for the type of institution needed for enhanced global governance. Established to coincide with the 1992 Rio Earth Summit and support both UN Climate and Biodiversity Conventions, the GEF makes grants, not loans, and involves two UN bodies (UNEP and UNDP). It has increased NGO participation. Though its funding is grossly inadequate, its organizational model is far better aligned with the critical sustainability challenges than is the World Bank—by definition, a lending institution.

Beyond funding a new form of development, a new global institution would also have to absorb the functions of the WTO, forging new rules and enforcement mechanisms to redirect development toward more equitable outcomes than the current pressures toward unfettered trade liberalization. In this context, we must revisit Keynes' proposal for an international clearing house to international governance of transactions of goods and services.

CONCLUSION

Our current mode of exhausting finite resources and generating wastes beyond the capacity of biogeochemical systems to recycle them is not sustainable. Worldviews, like physical systems, are beginning to shift. And once things start to change, they can change fast.

The international tasks that lie ahead loom large, for corporations must ultimately realize rewards for promoting less, not more; a 180-degree turn away from the conventional model of driving unending levels of consumption as the foundation for measuring success. The misalignment of financial systems and new models of business is a disconnect that must be rectified if timely, affordable, and patient capital is to flow into sustainable enterprise.

In all respects, we appear to be at the juncture of a packet of waves of different wavelengths, where the 30-year cycles and the 60-year Kondratieff boom-and-bust cycles have crashed along with a 500-year wave of western civilization. Suddenly, we face critical turning points in social and natural systems. It is a critical moment to rethink and repurpose international finance institutions such that they become the vanguard of the next wave of global change—change targeted at building sustainable societies of which finance shifts from an exercise risk gaming to one in which it becomes a core driver of positive social change.

A test of the political will and vision of world leaders for spurring such change will occur in December, 2009 when nations will meet in Copenhagen to create the post-Kyoto climate regime. These deliberations will include representatives from civil society, business, and the scientific sectors. This gathering of the global community to meet this global challenge can be the vehicle that sets us on a path to reshape the financial architecture.

We cannot afford to balk. In this nation we will need a Manhattan Project to study new technologies, a Marshall Plan to finance them, an Apollo Plan to launch them and, a new New Deal to sustain the transformation.

Constructing a new economic order built on equity and conservation shaped by a regulatory, institutional, and financial framework, will require a "Bretton Woods II," this time with government, corporate, scientist, labor, NGO, and civil society participation. Creating new governance architecture with adequate levels of funding and financial regulatory power can provide the scaffolding on which to construct and sustain healthy, ecologically-sound, and equitable global systems in the centuries before us. ■

Tomorrow's Owners:

Stewardship solutions for a better capitalism

MARK GOYDER
TOMORROW'S COMPANY

THE CASINO ECONOMY AND THE FAILURE OF STEWARDSHIP

London. 8 October 2008. It was a day of reckoning for the casino economy. On that day, the U.K. government announced that it had taken ownership stakes in the major banks, Lloyds TSB and Royal Bank of Scotland. This led to the resignation of Sir Fred Goodwin, CEO of RBS, who had led them through a number of successful acquisitions before becoming one of the most energetic collectors of toxic assets.

It was only some months later that the British public, who are now paying for the bank's misjudgements, learned that the RBS board had used its discretion to protect his pre-retirement pension with the effect of giving him a taxpayer-funded pension of £700,000 a year from the age of 48.

The original failure to challenge a powerful CEO, and thereby manage the banks' risk, is an obvious failure of stewardship. The board's positive decision to reward failure in this way suggests a staggering insensitivity to the expectations that society has of business. Shareholders were expressing unease about Sir Fred's management style and acquisitive habits as early as 2005. The scale and nature of Sir Fred's remuneration reflects flawed thinking about the whole nature of success and reward in business—appointing stars and then according them deference that is usually reserved for magicians and rock stars. In RBS, dealmaking and expansion by acquisition were richly rewarded: teamwork, loyalty and long-termism were not. Boards and investors failed to understand how large culture looms in the risk profile of a company. In Halifax Bank of Scotland (HBOS)—the other U.K. bank that failed—one dominant corporate banker, Peter Cummings, took an equity-with-loans approach that left it with debts of over £7billion. In RBS no one on the board or among senior colleagues was strong enough to challenge Sir Fred Goodwin. In HBOS Cummings was, we are told, held in awe and promoted to the board whose job it was to challenge his strategy. Moving outside the U.K., the culture at UBS was so dysfunctional that senior sales-driven executives simply overrode established internal control policies forbidding them to flirt with further U.S. tax schemes

The *London Financial Times* of 8 October contained another news item on the theme of ownership and stewardship. This was the denouement of a long-running involvement of the activist speculative investor, Robert Tchenguiz, and the pubs and hotel company, M&B. For some time Tchenguiz (a well-known client of Peter Cummings of HBOS) had been trying to use his investment in the company to force it to sell off its property into a joint venture with one of his companies. This in itself was not unusual. What did seem strange was that he was able to get the company to treat him like a major shareholder—to the extent that he was granted the right to nominate two directors to the board—when he did not actually hold any shares at all. What he had was an option to purchase shares called a contract for difference (CFD)—a derivative—that meant that at any time he could convert a derivative into a holding worth 25 percent of the company.

The company eventually acceded to his demands; but then, because of the credit crunch, the funding for the deal fell away and the company was left with a loss of over £300m on hedging arrangements it had made in conjunction with the deal.

As the market continued to fall Tchenguiz then found himself being cornered by traders who were now short-selling M&B and driving down the value of his potential holding. In order to short-sell you have to borrow the shares. Tchenguiz decided to convert his derivative holding into a real holding, not so much because he wanted to be a real shareholder as to prevent other people short-selling the stock on which he had bet!

Now he was a real owner: at least he fully owned the shares he had paid for. But that was still not the end of the story! The end came on 8 October when it was revealed that, because Tchenguiz had borrowed the money to buy these shares from an Icelandic bank, he had now been forced to sell his holding at a discount. M&B were at least free from the attentions of an "owner" who had little interest in its long-term success, and the company is now trying to find its way back to its previous course, nursing hedging losses caused by this deal which exceed £300m. Meanwhile, Tchenguiz is now embroiled in legal disputes with his Icelandic bankers.

This is a parable of the casino economy. An investor who is not interested in the long-term health of the company can, effectively, use a derivative to put his tanks on the company's lawn without formally owning shares in the company. It prompts the question: should a company have to treat all investors the same, even where some of those investors are less interested in its long-term health than in forcing break-up or disposal for their speculative gain?

WHY STEWARDSHIP MATTERS

Capitalism is in trouble because stewardship is failing. Some of the reasons for this failure are global: they relate to the depersonalization of ownership, the explosion of derivatives, and the introduction into financial services of new layers of intermediation which erode personal responsibility. But, as will be argued later in this paper, stewardship is also failing because of a flawed understanding of the relationships and dependencies that underpin corporate success.

While it impossible and undesirable to roll back many of the forces that have created the casino economy, we can reinforce stewardship, and we can also rediscover the ingredients of success to which good stewards must always turn their attention.

Which brings us to the third news item for 8 October—the publication of a new report on the nature of ownership. (Tomorrow's Company 2008)

This report starts by making a distinction between the real economy—producing goods and services that meet human needs and the banks and investors that support the real economy—and the casino economy—activities which are removed from the production of goods and services and where prices may have little relation to the underlying value of what is being traded.

The report dissects the concept of ownership. Companies are separate legal entities which own their own assets. Ownership consists of a "bundle of rights" which are exercised to a degree by shareholders and to a degree by directors and by others.

The report argues that shareholders have four main ownership-related roles, of which stewardship is the most important:

- **Member—**setting the rules, voting , attending the AGM;
- **Analyst, or scrutineer—**assessing the company's potential and ability to deliver;
- **Financier—**providing equity funding in an IPO or rights issue;
- **Steward—**promoting sustainable, long-term, performance.

The rights and duties of shareholders give them a stewardship role alongside that of directors in protecting the long-term health of the company and promoting the long-term value of the investment. Directors are entrusted by shareholders with the management of the company on a day-to-day basis and are accountable to—and can be influenced by—shareholders. Thus, the core responsibility for stewardship is shared between shareholders and directors—a vital point.

The report goes on to define stewardship:

"In Tomorrow's Company we see stewardship as the process through which our shareholders, directors or others seek to influence companies in the direction of long term, sustainable performance that derives from contributing to human progress and the wellbeing of the environment and society."

THREE CONNECTED SYSTEMS

So is stewardship in retreat and, if so, why?

Even before the recent financial crisis profound changes were evident in the patterns of company share ownership, both in the structure of companies and the nature of their shareholders.

Globalization and technology have facilitated the emergence of new financial institutions and derivative instruments. At the end of 2007 the Bank of International Settlements estimated the notional amounts of all "over-the-counter" (OTC) contracts as $596 trillion—or $88,000 worth of derivatives for every man, woman, or child on the planet!

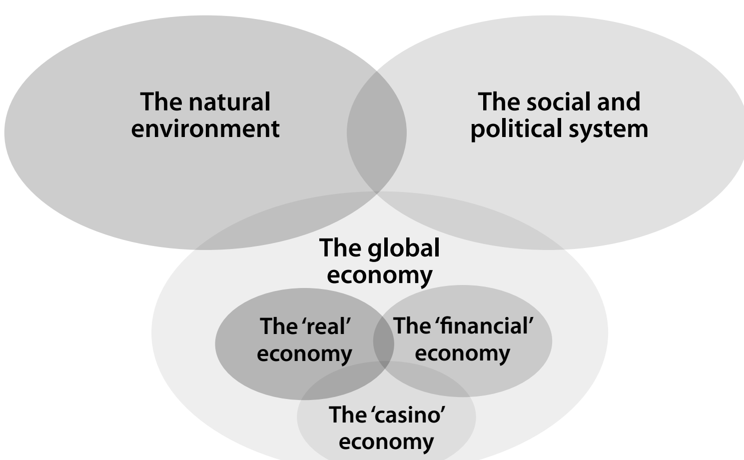
Companies depend for their success on the health of three connected systems—the natural environment, the social and political system, and the global economy. This interdependence for companies was described in *Tomorrow's Global Company*. (Tomorrow's Company 2007).

If we break down the global economy, we can see it as consisting of three inter-related sub-systems (Figure 1).

Figure 1

GLOBAL ECONOMY

3 inter-related sub-systems



- the **'real economy'**—producing goods and services that meet human needs.
- the **'financial economy'**—banks, investors and intermediaries which support the 'real economy.'
- the **'casino economy'**—activities of those linked to the 'financial economy' which are removed from the production of goods and services and where prices set may have little relation to the underlying values of what is being traded.

THE RISE OF INSTITUTIONAL INVESTMENT

According to one study, at least 310 million people in 59 countries (24 developed and 35 emerging-market nations) own stock directly. Nearly 173 million of these investors live in countries with developed stock markets, and the remaining 137 million reside in countries with emerging stock markets. At least 503 million individuals in 64 countries own stock indirectly through pension-fund holdings. (Grout et al. 2009) Within the listed company sector, there has been a shift in many developed economies from individuals to institutions. In the U.S., according to John Bogle, institutional ownership has grown from 8 percent in 1945 to 75 percent today. (Bogle 2008)

Individuals held over half of U.K. shares in 1963. By 2008 they held around an eighth. There has also been a rapid increase in foreign shareholders. For example, in the U.K., foreign investors held less than a sixth of the shares in 1993 but, by 2007, the U.K. Treasury was reporting that foreign ownership of the U.K. quoted corporate sector had reached approximately 50 percent. Domestic institutions such as pension funds and insurance companies held over half of U.K. shares around 1993. Today their share has slipped back to about a quarter.

PENSION FUNDS REMAIN DOMINANT

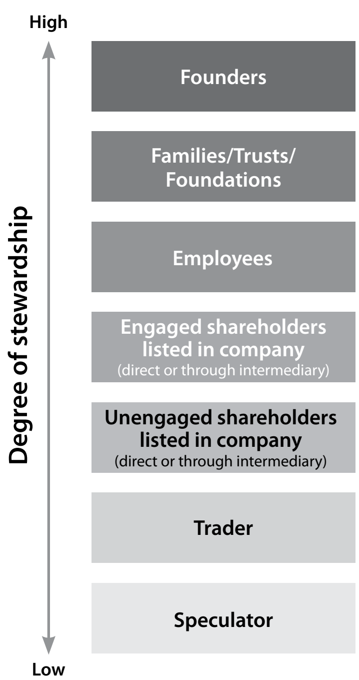
In spite of the attention given to hedge funds, sovereign wealth funds, and private equity, these new entities are overwhelmed by a factor of ten by the world's pension funds, mutual funds, and insurance funds. Although institutional investors are often seen as having a contrasting approach to alternative investment vehicles, they are increasingly investing part of their portfolios in private equity and hedge funds. On average, shares also are being held for shorter periods, although this could arise from some shareholders churning shares faster and faster while others maintain long-term ownership.

THE LISTED COMPANY IS THE EXCEPTION, NOT THE RULE

While the retreat of stewardship is most obvious in the listed company sector, it is important to keep a sense of proportion. The listed company with widely dispersed shareholders may be dominant in the U.K. and U.S., but it is not the worldwide norm. For example companies with "block holders"—where a single owner has more than 20 percent of the shares—account for 60 percent of market capitalization in Germany, France, and Italy. Worldwide, most companies are unlisted. There also is a shift in the balance of power from developed to emerging economies, with an increase in the number of acquisitions of companies in the OECD countries by those from emerging economies.

Figure 2

SHAREHOLDERS STEWARDSHIP SPECTRUM



THE STEWARDSHIP SPECTRUM

Tomorrow's Company has plotted different types of shareholders and their propensity for stewardship (Figure 2).

This stewardship spectrum indicates the likely position of a type of shareholder. At one end of the spectrum, founders or founding families tend to be very strong in their stewardship attributes while, at the other end, speculators exercise no stewardship responsibilities whatsoever.

It is impossible to categorize whole types of investor or investment as either "good" or "bad." At its best private equity is the epitome of strong stewardship, jointly exercised by investors and managers. Hedge funds can enhance the sharpness of market judgements and identify corporate weaknesses long before "patient" institutional investors. Derivatives can help to lubricate markets even though some of them, for example contracts for difference, have been used to undermine stewardship. The best of the continental European "block" investors enhance stewardship while the worst abuse the rights of minority shareholders. It is a question of balance, and if the casino economy marginalizes stewardship to the detriment of the well-being of real economy and, beyond that, society and the environment, then corrective action is needed.

INGREDIENTS OF SUCCESS

So stewardship is being undermined. This is the first flaw in current capitalism, and we need to take steps to reassert it across all types of ownership

But whatever your form of ownership, stewardship will be ineffective if it is based on a restricted understanding of what drives long-term success in a company. It is hard to focus on the long term if you have no effective means of assessing long-term progress and prospects.

The second flaw in contemporary capitalism derives from our neglect of the true sources of enduring success in companies. Our investment and governance methodologies lack rigor. They fail to reflect a deep understanding of the drivers of long-term business success—leadership, values, relationships, culture, and behaviors. Because we do not recognize these factors we do not have the tools or the language or the measurement frameworks to evaluate the company's potential for longer-term success, or properly to manage its risk.

And that is exactly what has gone wrong. For an illustration of this flaw, we need look no further than value destruction that has just occurred in the complex chain that linked mortgage lending, through securitization, and collateralized debt obligations to the ultimate creation of toxic assets. In financial services, unlike in other sectors more exposed to the public gaze, managers surrendered to the idea that success is pursued by making as much money as the law allowed without regard to how it was made. The complexity and opaqueness of their production processes has allowed something that the public stopped tolerating long ago in other, less complex, industries.

Take footwear as an example. Thirty years ago, retailers would be quite content to source the shoes they wanted to sell as cheaply as possible. The working conditions of those who produced them were not their concern.

Then headlines and protests developed. Society started to hold them responsible for previously invisible working conditions. Companies such as Nike went through a transformation. They realized that they were polluting their brand. Global sourcing became visible. It was no longer viable to define success simply in terms of buying at the lowest price and selling at the highest.

Financial services and investment are today where footwear was 30 years ago. I was talking recently to a very senior investment banker, whose firm was exceptional in the ethical controls that it exercised over its product development. In spite of this, he told me that, repeatedly, new product ideas had been put in front of him without any prior thought about their ethical content. The product developers simply did not make the connection between innovation and ethics, and ethics and risk. His business—one with a strong family involvement—survived the crisis because there was a process of stewardship which applied ethical brakes to this process. Others did not.

Consider the building up of huge portfolios of loans to poor people in U.S. trailer parks. These loans were authorized without proper scrutiny of the circumstances of the borrowers. Somebody else then deemed them fit to be securitized…and so on through credit default swaps and the rest without anyone seeing the transaction in terms of its ultimate human origin.

Each of the decision-makers thought it okay to act like the thoughtless footwear buyer of the 1970s. The price was attractive. There was money to make on the deal. Was it responsible? Irrelevant! It was legal, and others were making money that way. And the consequences for the banking system if everybody did it? Not our problem! Where is the bank or insurance company board member who stopped to challenge their company by asking exactly what was the human origin of the debt they were so happily repackaging?

Now we are paying the price in trillions of dollars for that imprudent attitude.

SHAREHOLDER VALUE—A GOOD MEASURE BUT A BAD MASTER

The natural laws of capitalism to which we need to return, would start with the idea that shareholder value is a good measure but a bad master. The natural starting point for a business is meeting a human need. And no business will continue for long if it fails to meet a human need. There is nothing wrong with constructing economic models on the assumption that everyone has the same profit-maximizing ambitions. Such caricatures are very helpful in the construction of theoretical models of behavior. The danger lies in taking what is simply a set of assumptions and elevating them into a set of natural laws which all business people are expected to obey. "Let us assume this is how everyone behaves," has in some minds become: "This is how everyone behaves all the time," or even "This is how people in business ought to behave...."

The problems arise when half-truths are claimed as whole truths, and exclusive statements of purpose replace inclusive ones. "We are here to create value for our shareholders" quickly becomes corrupted into: "We are here only to create value for our shareholders," and ultimately into "never mind the future—give us the money now."

Exclusive messages are bound to end up as dishonest messages, because the company itself has to contradict them in its battle to win the loyalty and trust of whole human beings who divide their time between their roles as customers, employees, shareholders, and members of communities.

This is the underlying flaw that has hollowed out trust from our banking system—at the wheel have been fast-driving CEOs with no stewardship brakes. Following on behind are unquestioning slaves of a fee-driven culture where long-term relationships and the responsible assessment of human impacts are sacrificed to greed and selfishness.

The two failures of capitalism reinforce each other. If we had a clear metric for separating companies with wholesome cultures from companies with flawed cultures, it would be easier for investors to exercise stewardship. If investors or their proxies were more interested in stewardship, there would be more demand by companies for such metrics, and managers would behave better. We have to find a way, short of Sarbanes-Oxley-style prescription, of creating the pressures whereby metrics will reinforce the stewardship and the stewardship will reinforce the metrics.

An Inclusive Approach

How do we think of companies? On the one hand there are people, like many of those employed in financial services, who have thought of companies as machines—as impersonal, ruthless, wealth-maximizing engines, a bundle of contracts, all pointed in the general direction of maximizing value for shareholders. Their thinking is based on a one-dimensional view of human motivation, and they have no way of explaining why some companies engage their people more; why some achieve higher prices through the value of their brands; why some derive more help and innovation throughout their supply chain, and are given the benefit of the doubt by local authorities and regulators.

The answer lies in values and behaviors (Box 1). Employees look for more than wages from their work. They look for meaning and a sense of belonging to something bigger than themselves. Customers want the goods and services they buy to perform well technically, and be good value for money, but they also want to feel good about consuming them, and in most situations they are prepared to pay more for this emotional component.

This is why it makes sense to think of companies as living organisms, and as associations of human beings rather than economic machines. Companies are started by entrepreneurs. They are all different. As they grow, their wealth-creating capacity depends on maintaining a combination of entrepreneurial spark and constant values in all their relationships. They stand or fall by their reputation. How they behave will ultimately determine how much value they create. Successful companies are those which are most effective at serving human purposes, and human needs. (Tomorrow's Company 1995)

Companies which allow a gap to grow up between the needs of society and the needs of their shareholders are, ultimately, plotting their own downfall, as the U.S. car industry can testify. It can sometimes take decades, as in the case of the tobacco companies, but eventually the pressures of society do make themselves felt. While society must set rules and limits, the real key to enduring success is to promote and reward high-quality business leadership, and to set companies free to fulfill their potential in bringing out the best in human beings and contributing the most to society.

AND THE PRACTICAL TOOLS

We now need more than just a commitment to restore stewardship: we need the tools that underpin it. As I argued in *Lessons from Enron* we need to develop a methodology for assessing the health of a company's culture, the robustness of its values, the strength and consistency of the leadership and behaviors that will drive its reputation and its brand value and, so, in the longer term, its share price and its underlying economic value. (Goyder 2002) The know-how exists in each relationship: I know at least one HR consultant who has already developed his own "Killer HR questions that every investor should be asking of companies."

Box 1

TOMORROW'S COMPANY: AN INCLUSIVE APPROACH TO BUSINESS SUCCESS

Tomorrow's Company

- Clearly defines its purpose and values, and communicates them in a consistent manner to all those important to the company's success;
- Uses its stated purpose and values, and its understanding of the importance of each relationship, to develop its own success model from which it can generate a meaningful framework for performance measurement;
- Values reciprocal relationships, understanding that by focusing on and learning from all those who contribute to the business, it will best be able to improve returns to shareholders;
- Works actively to build reciprocal relationships with customers, suppliers, and other key stakeholders, through a partnership approach; and
- Expects its relationships to overlap and acts, with others where necessary, to maintain a strong "license to operate."

From RSA Inquiry Tomorrow's Company 1995 p1

LEGISLATORS CAN PROMOTE INCLUSIVE BEHAVIORS

In the past, I have characterized the first group of people as people who think "firm" and the second as those who think "company." Why? Because the origins in the word "firma" are in the Italian for the stamp that seals a contract. The origins of "company" on the other hand are first a military grouping of soldiers but, ultimately, the group of people with whom you share your bread. (Goyder 1997)

The divide between those who think "firm" and those who think "company" applies as much to debates about how to regulate business as to how it is led and governed.

If you see the company as a relentless, impersonal machine, rather as Joel Bakan does in "The Corporation," then the company is the problem. The only answer is to exercise restraint from the outside, either by seizing the shareholder citadel so companies are forced to obey different shareholder orders, or by imposing societal rules.

If, on the other hand, you think "company" rather than "firm," you adopt a different set of principles by which to design regulation. It leads you to conclude that society needs entrepreneurial businesses—but if it is to benefit from their creative potential it needs them to operate in a context of self-discipline, so that regulation is left to create a broad framework not a straitjacket for their activity. And this is where good stewardship comes in—as the custodian of responsible behavior which makes trust and flexibility possible. Good stewardship paves the way for an enterprise-friendly climate. The betrayal of stewardship brings with it the loss of public confidence and the backlash of rigid regulation.

Significantly, an inclusive approach already has been taken up by lawmakers in the UK. The new definition of directors duties, enshrined in the *Companies Act of 2006*, is an inclusive definition of the duties of directors—in other words, its starting point is the proposition that the future success of companies lies in the quality of their leadership and the health of their relationships, and it is on these elements that sound governance and reporting should focus alongside the immediate financials (an inclusive approach). Hence the duty imposed by the 2006 Act for directors to have regard to the interests of customers, employees, suppliers, the community, and the environment in pursuing the success of the company. This offers a pattern that should and will in time be adopted in other jurisdictions.

You cannot make companies into charities or civil society organizations. Their profit-seeking nature is essential to their success. What you can do is create the limits within which leaders pursue that success, and also use the rules of good governance, transparency, and accountability to allow society to satisfy itself that companies are being run in a trustworthy way.

There are other precedents. When I first worked in a manufacturing business as a young personnel officer in the 1970s, I found myself being put in charge of health and safety in an engineering factory which employed 1000 people. It was shortly after the introduction of the *Health & Safety at Work Act of 1974*. This was, in my experience, a very effective piece of legislation. It devolved onto each business the duty to say how exactly that business defined health and safety. Each company had to write its own safety policy. And, to ensure that it was held accountable for implementing the policy, the legislation required the creation of Safety Committees and, in the case of factors with trade union recognition, there was the added accountability of trade-union-appointed safety representatives.

The act set out a framework and principles but left the individual company with freedom to apply those principles in ways that were appropriate to local circumstances. This is the spirit in which all participants should work to re-establish stewardship and the inclusive approach.

STEWARDSHIP AND INCLUSIVENESS IS EVERYBODY'S BUSINESS

Building and sustaining inclusive organizations is a multi-faceted challenge that demands the commitment and skills of all stakeholders within and outside the organization.

Examples of the roles of each player

illustrate the range of contributions that collectively build high-performing, enduring, and socially-purposeful companies.

Chairman, CEO and Board Members

1. Ensure that a culture of challenge operates in your company: have a clear method of profiling that culture and review it regularly. Insist that values and behaviors command as much attention from the CEO and executives as do financial performance.
2. Make the culture of the company, and its leadership style and principles, a key part of the induction of every new board member, and of its risk management processes.
3. Insist that the board receive a report at last twice a year on the company's values and behaviors, and that these are the basis for the induction of board members.
4. Ensure that your company has its finger on the pulse of the relationships that will determine its future success. Satisfy yourself that the company's measurement scorecard and the numbers and indicators regularly reported to the board include relevant material on the perception of your company by, and the health of its relationship with, its customers, suppliers, employees, community, and shareholders.
5. Never fall into the trap of relegating values to a ghetto called corporate responsibility or, even worse still as happens in some companies, "CR values."

Pension Funds and Asset Managers, Private Equity, Hedge Funds and Sovereign Wealth Funds

1. Review your valuation methods and your risk management methodology. Understand the contribution of a company's culture to its reputation and brand values. Draw on the know-how of experts in leadership, risk management, and in employee and all other stakeholder relationships so that you can improve your profile of the well-led and well- governed company.
2. In your dialogues with the company challenge it on these issues and make it clear that it is central to your concerns as an investor—not a fringe concern for the socially responsible investor alone.
3. Empower the ultimate beneficial investors to express their preferences through the investment system. Step up your research into the priorities and expectations of your clients, whether these are governments, pension funds, or individual clients, and show them how they can make choices and have influence. Ask them, for example, whether they would like you to place more value upon well-led, well-governed companies in the way that you already have started to emphasize their attitudes to environmental sustainability. (Tomorrow's Company 2004)
4. Become signatories of the (UN) Principles of Responsible Investment and report publicly against them.
5. Encourage learning and spread accountability across different forms of investment. Create new tools and frameworks that can be used across all. For example, it makes no sense for a private equity owner, intent on transforming a company's fortunes, to ignore reputational risk in doing so. Institutional investors can learn from private equity and family businesses in holding managers to account and making sure remuneration is well-judged and not excessive. When pension funds and other institutional investors invest in hedge funds—or indeed private equity—they should set mandates which hold those investment vehicles to account. Institutions should ensure that the methods used by those they invest in do not contradict their own purposes as custodians of their members' savings. They should also ask whether their stock lending is justified in the light of their overall objectives.

NGOs, Stakeholder Organizations, Trade Unions, Commentators and Journalists

1. Be clear in your own mind what good stewardship means to you and how you define a well-led company.
2. As well as condemning and exposing the weak, focus on and celebrate the excellent.

Lawmakers and Regulators

1. Take an inclusive approach to company law—see U.K. companies Act and King III Report on Corporate Governance in South Africa.
2. Professionalize financial practice: bind all those who handle our money to professional codes which spell out the obligations they must fulfill to society and their customer in exchange for their continuing license to practice. Would-be investment bankers, dealers, fund managers, and investment consultants would be required to swear their own version of the Hippocratic Oath, the promise to "do no harm." Those found guilty of scams, insider trading, misrepresentation, or putting their own interests before the interests of their customers or of society could face disciplinary investigation and ultimately suspension from their profession.
3. Professionalize the board—executives and non-executives alike. (At least under U.K. company law, they all have the same duties to the company.) Most countries have a professional qualification for directors: in the U.K. it is called Chartered Director status, and Tomorrow's Company has proposed that government should impose upon listed companies the requirement that by, say, 2015 a minimum of half of all their listed company board members are professionally qualified. With professional qualifications should then come that same ethical obligation to do no harm to shareholders, customers, stakeholders, and future generations in the same way as medical professionals are bound to do no harm.
4. Resolve the conflict between independence and expertise. In the recent past there has been too much emphasis on ensuring board member independence. Now people are asking if it isn't more important to have people on a bank board who know about banking. The answer is to be found in a split approach: a percentage of board members need to be able to demonstrate independence. A percentage need to be able to demonstrate the deepest levels of industry and even company know-how and experience. Neither percentage should be as high as 100 percent. Boards need the feisty NGO head who may never have worked in the industry: they also need the experienced former executive who cannot be said to be independent.
5. Report on ethical and culture risks. The time has come for ethical audits with teeth—for a rigorous process in which independent observers check the gaps between the stated values of the business and its actual behaviors—and the board are forced to confront this because the results will be published. In the U.K. context this is best done by bringing back the mandatory Operating Financial Review (OFR), which the government developed and then watered down. To this would be added a discussion of risk management, and a section dealing with the company's values and behaviors, with an independent external auditor's comment alongside the boards' own commentary. The Chairman would then be required to report on this in a separate agenda item at the Annual General Meeting.
6. Rebalance remuneration. Remuneration needs to be rebalanced so that it rewards performance over the whole cycle, with provisions for deferral and claw back, and a balance between teamwork and individual achievement. The Remuneration Committee should be required to explain whether remuneration policy promotes desired or undesirable behaviors. There should be a clear description of the ratio between the lowest and highest paid, and a published explanation of the need for these differentials. Don't limit the quantum, but use transparency to force boards to explain it.
7. Empower long-term approaches and penalize speculation where it gets in the way of this. This is easier said than done. But there are a number of circumstances where governments and regulators will need to intervene to help create the climate for stewardship. Here are examples of situations in which careful thought will be needed:
    a. whenever the provisions that allow market liquidity spill over into

rewarding speculation at the expense of long-term ownership—as in the Robert Tchenguiz example.

b. Whenever the tax system appears to favor derivative forms of shareholding over real shareholding (as in Contracts for Difference).

c. Whenever competition law gets in the way of companies collaborating with each other to create a more sustainable "level playing field" of responsible practices.

d. Whenever market participants promote their own interests at the expense of the health of the system as a whole—for example, investment consultants who make most of their income by encouraging their pension fund clients to "churn" asset managers instead of developing longer-term mandates, incumbent boards which use their position as insiders to engineer buy-outs on lucrative terms, or other fee arrangements or collateralized debt obligations which create systemic risk.

e. Whenever companies need protection to develop deeper dialogue with their longer-term investors and are unwilling to accord the same privileges to investors who they do not judge to have their long-term interest at heart. Why should a CEO extend the same time and co-operation to an investor who is seeking to profit by movements in the company's share price as a long-term intrinsic investor?

7. Fiduciary Duty and Sustainability. In some jurisdictions, the shift towards stewardship behaviors may need changes in the law. It is now clear that fiduciary duty extends beyond pursuing immediate financial returns to beneficiaries. It covers responsibility for enhancing the operation of the investment process so as to ensure that those financial results can continue to be delivered in the future. Pension trustees, and all those who handle savers' money need to build this understanding into their approach. If the law already allows this, then the focus shifts to education. But if there is any doubt about the law, then the first step is to change the law**.**

CONCLUSION

The world needs shareholders whose priorities and behaviors are aligned with the long-term interests of the company, and with the health of the soil in which it's being nourished. It needs boards and investors who exhibit a deeper understanding of the ingredients of success, and who have the tools of analysis by which they can advance this understanding. As with most complex problems of this century, the solution does not lie with any one group. We need investors, boards, rule-makers and civil society to work together to develop an agenda which puts stewardship and an inclusive approach at the heart of corporate life.

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The Origins and Costs of Short-Term Management

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WHY IS A FIXATION ON THE SHORT TERM a problem for American businesses? One might hasten to answer that management is compensated for short-term successes. Another answer might be that some investors—particularly professional investors—value only the short term and manipulate the market in a particular stock so they can profit on the movement. These answers undoubtedly are part of the answer. But a puzzle remains: why does the market not punish such short-termism? This essay will present a possible answer.

JIM CRAMER, JON STEWART, WALL STREET, AND MAIN STREET

Jon Stewart expressed the outrage of many when he recently called CNBC's Jim Cramer onto the carpet for cheerleading the greedy, risk-addicted, finance-driven economy of the last decade.[1] Stewart decried the existence of "two markets," one for regular folks who put their money away for the long term, relying on the assurances of Cramer and his ilk that the stock market was a safe, long-term investment for their retirement savings. The other market, according to Stewart, was where those in the know used capital accumulated from pension investments and small- scale, retail investors to build personal fortunes based on increasingly risky and dubious financial products. Those in this exclusive market made bets with billions of dollars of capital gathered from regular folks, and when they lost their bets the rest of us were dragged down with them.

Stewart's description is certainly not complete, but it certainly captures the sense that many of us have in the midst of the current crisis, that the financial markets have taken us as chumps. For most of us with investments, we're worse off than if we had put our cash in our mattresses for the last decade. And this is not even to mention that those of us who depend primarily on wages for our income—as opposed to investments—are no better off in real terms than our parents were in the early 1970s.

The causes of the financial fiasco are many, and scholars already are beginning to tell coherent stories about the numerous reasons why we find ourselves where we are. The over-dependence on derivatives, the overuse of leverage, the culture of greed and entitlement in the finance industry, the pervasive assumption of an ever-rising housing market, and the emphasis on finance as the economy's driver rather than production all deserve attention.

There is another cause for the economic downtown that deserves study—the focus on the short term within corporate governance. If managers, officers, and directors had taken a more long-term view of the health of their own companies and the fortunes of their investors, we might not have seen the other problems come to such a head. The addiction to leverage, derivatives, and greed that caused the market to become a casino would only have been possible in a business culture where short-term gains are prioritized over long-term costs.

And what's worse, the short-term gains went to a handful of corporate executives, financiers, hedge and private equity funds, and banks, while the costs are now being borne by everyone. And what might have been assumed to be costs that would be suffered in the long term—sometime in the future—are being absorbed now. John Maynard Keynes was wrong on this point: in the long run, we're *not* all dead.

What caused Wall Street's fixation on the short term? The answer is indeed complex, and this essay will not attempt to provide a comprehensive answer. The focus here is to provide some comments on one aspect of the question; namely, why is there a short-term problem at all? And should Main Street care?

THE SHORT-TERM PUZZLE

Many analysts of the corporate world have long remarked that a fundamental problem with the way corporations are managed is the phenomenon of "short-terminism." Despite some naysayers,[2] the problem is very real. Shareholders hold their stocks, on average, for less than a year, and even less for small companies.[3] Institutional investors have been said to be particularly bad on this front, acting "more as traders, seeking short-term gain."[4] Managers admit that they make decisions that harm the company in the long term in order to meet short-term earnings expectations.[5] In 2006, the Conference Board and the Business Roundtable, two of the nation's most prominent business organizations, both issued reports "decrying the short-term focus of the stock market and its dominance over American business behavior."[6]

Short-termism is fairly well documented, but its existence is befuddling and its implications unclear. Why, for example, would a company benefit from short-term management? Why would share prices be inflated for such a company, rather than depressed?

Consider that any shareholder who sells her stock in order to profit in the short term is selling to someone else, who by definition believes that the stock is selling for less than it is worth. Share turnover is not by definition a problem, then, since for every seller there is a buyer. Moreover, it ought to be irrational for Wall Street analysts to require—and company management to make—decisions by the company that hurt the company in the long run but allow the companies to meet short-term earnings projections. In such situations the share price should *fall* rather than increase or stay steady. The reason is that, in an efficient market, share price is a reflection of the company's value. If decisions are being made to decrease the true value of the firm then the share price should reflect that.

To offer a concrete example: let's say a company chooses to adjust its accounting treatment in such a way as to accelerate earnings and delay costs for the current quarter. This will give the *appearance* of a greater profit in the current period, perhaps allowing the company to report to Wall Street analysts that the company has met its earnings expectations. But no rational, informed investor would pay a higher price for shares in such a company since the company's value *has not changed in reality*. They are still making the same products or providing the same service. Their long-term prospects have not changed for the better and may have changed for the worse, if the management has been spending its energy on accounting rather than productive pursuits.

Indeed, if the company is in fact being managed for the short term at the expense of the long term, then the share price should *fall* dramatically and consistently. The rational buyer would not be willing to pay any more for each share than the sum of the total dividend payments coming to her in the future on the basis of that share (discounted to present value). And if shareholders know that the company has made future dividends less likely because of management's short-term orientation, then the market price of the stock will reflect this even if the short-term earnings are inflated. Indeed, share price should be expected to fall consistently over the period of such managerial strategy. Again, to make the point concrete: if managers intentionally manage a company to accelerate all profit and earnings into the next five-year period and then go bankrupt, no informed shareholder should purchase shares of that company at the current price. The shares will be worthless in five years, and fall dramatically in value between now and then.

All this is to ask: Why is short-termism a problem? Why does the stock market not punish companies managed for the short term?

SHORT-TERM STRATEGIES

In figuring out this puzzle, allow me to make an assumption that will simplify the analysis as we go. Allow me to assume that there are two kinds of companies: one that manages for the short term and one for the long term. The short-term company seeks to maximize profits and earnings in the near future, with disregard for the long term. If decisions can be made to transfer value from the future into the present day, the management will do so, even if it will decrease the total value of the firm aggregated over time. (We'll set aside for the moment *why* management would do this.) Long-term-oriented companies will make decisions that seek to maximize the value of the company over time. If decisions can be made in the short term that cost the company money but will pay returns in the future, then the company will do so, even if in so doing the company will be unable to recognize profits in the near future.

In a company whose management team is oriented toward the long term, one would expect to see a greater-than-usual dedication to sustaining the company as a going concern over time; a larger commitment to maintaining the loyalty of those who have made investments in the company, whether by way of capital, infrastructure, or work; a dedication to the development of products or services that will pay off in the future; a diversification of firm endeavors and investments to guard against short-term shocks in the financial or consumer markets; and so on.

On the other hand, a company focusing on the short term will also have a number of strategies at its disposal. Here is an illustrative list, hardly exhaustive:

- Cuts in research and development, in order to use the capital that would be spent for R&D to increase dividends or retained earnings temporarily, at a cost to the long-term health of the company;
- Accounting adjustments (either legal or illegal) to accelerate recognition of revenue and delay recognition of expenses, inflating current earnings at the cost of deflating future earnings;
- The sale of profitable divisions or subsidiaries for cash, realizing future earnings of the division as a cash payment in the present, usually at a discount;
- A greater dependence on debt to finance company expenses and projects, which increases the company's leverage, inflating returns on equity as long as the company is doing well and the market is trending up, but at a cost of increased risk of insolvency if the market goes down;
- The use of executive compensation schemes that prioritize the satisfaction of short-term financial goals, incentivizing management to look only a few steps ahead;
- Breaches in implicit or explicit contracts and understandings with company stakeholders, which allow the company to seize the value of past investments by such stakeholders without paying them their expected returns (an example of this would be a change in company policy away from a commitment to providing stable employment and toward an increasing use of short-term, low-wage employment);
- Cuts in employment generally, since savings in labor costs occur in the short term and costs to the company arising from a decrease in employee loyalty and specific human capital valuable to the company are incurred in the longer term;
- A disregard for latent risks in the company's products or services, whether such risks be environmental (the risk of global warming brought about by the use of SUVs, for example), social (the social cost of violent media, for example), or financial (the risk of financial crisis brought about by the overuse of risky financial derivatives);
- Stock buy-backs, which increase share price in the short term but deplete the company's capital that could be used for a more productive purpose; and
- A focus on share price rather than the corporation's value as a whole or the value of the corporation to its non-equity shareholders.

Each of these short-term strategies will likely impose long-term costs onto the firm but have short-term benefits to the company, the management, or certain shareholders. There may be situations in which such long-term costs are worth the short-term gain—for example, when the company needs to satisfy some short-term financial obligation (to pay a legal judgment, say) and can only do so if R&D expenditures are put off. But by definition most of these strategies will be bad decisions for the firm in the long run.

I do not intend to say no company managed for the long term ever fails. Managers make mistakes, and some mistakes are quite costly. Moreover, to the extent that a company's time horizon is long, it may be more difficult to know whether a long-term strategy pays off than if a short-term strategy pays off. Also, a long-term strategy is more difficult: not only must a company's management make decisions that are focused on success five or ten or twenty years out, it must also make short-term, tactical decisions that work as well. A part of a company's long-term strategy must always be to survive in the short term.

As a public policy matter, it is important to encourage long-term management, since the economy as a whole benefits when companies have a long-term strategy. The economy is a summation of the fortunes of the millions of companies and individuals that make it up; if most companies make decisions that prioritize the short term at the expense of the long term then we all suffer. A nation's wealth grows more over time when companies invest for the future, maintain their viability as a going concern, and engage in business practices that are sustainable environmentally, socially, and financially.

BACK TO THE PUZZLE

So here we get to the nub of the problem: if short-termism is costly to companies in the long run (by definition) and to the economy as a whole (because the economy is a summation of the well-being of all of us) then why do we see the short-term management tactics described above?

Part of the answer lies in the fact that companies are controlled by managers, and some managers intend to be at the company for a long period of time and therefore look toward the long term; some managers want to make their money and get out.

So this might explain why some managers would *want* to manage their companies for the short term. But it does not explain why the market does not consistently punish such behavior. If managers make decisions that will hurt the company in the long term for selfish reasons, why does the share price not fall? One answer might be that some investors, too, focus on the short term, so that they buy up stock of companies so oriented. But that, too, does not answer the question, since short-term-oriented shareholders should not be able to realize any benefit from owning shares in a short-term-oriented company. If dividends are inflated in the short term at the cost of the long-term fortunes of the company, whatever benefit realized from the short-term dividends will be more than set off by the decline in the stock price brought about by the decline in the real value of the company.

In other words, if a company's short-term strategy is known to the investing public, then the future drop in the value of the company will be "baked in" to the current price. No benefit should be gained from such a strategy if indeed it is known to the investing public. As the costs of the short-term strategy become clearer, the stock price will plummet, and those holding the shares of such a company will find fewer willing buyers.

As for companies with long-term strategies, the future earnings will be baked in as well, so that the stock price will be trading at a fairly high price-to-earnings ratio. (The value of the future earnings will not be fully captured by the current share price, however, since investors will discount future earnings in relation to the time value of money and will also likely impose a "risk discount" in connection with the probability that the company will not actually realize the benefits of the long-term strategy.) All in all, in a perfectly informed market, the value of long-term oriented companies will tend to be recognized as such, and their share values will so reflect.

THE INFORMATION FALLACY

Of course this argument depends on an unreasonable and simplistic assumption—that the market is informed. In fact, investors are not perfectly informed, and it is often costly or impossible to determine whether companies are being managed for the long or short term. It is often costly or impossible to determine whether an increase in quarterly earnings is evidence of a short-term orientation that will be costly to the company in the long term, or the realization of returns from a successful long-term strategy.

This fact poses a significant difficulty for public policy. Profits and earnings for a long-term-oriented company may be indistinguishable from profits and earnings for a short-term-oriented company. It is easy to show the numbers; it is difficult for most investors to determine the reason for such numbers. In fact, a company that is utilizing some of the short-term managerial strategies listed above may show profits and earnings that are greater than companies with a long-term focus. And the capital market may not "punish" such short-term management if it is not clear that the inflated earnings are based on strategies that are costly in the long term.

When a company's management strategy is not known, or is not widely known, a company which is being managed for the short term may have a share price that is inflated, falling only when the strategy becomes clear and earnings begin to fall. Those investors holding this stock at the time of the fall will suffer the financial loss. A windfall will be gained by those who are holding the stock during the run-up of the stock price and who are fortunate enough to sell before the drop. Also, a windfall will inure to managers who time their departure before the drop.

As for long-term-oriented companies, the depressed short-term earnings brought about by the long-term strategy will not be easy to distinguish from depressed earnings caused by bad management or a short-term strategy that has run its course. The stock price will also be discounted because it will be unclear to investors what the true strategy really is. This, in turn, makes the company ripe for takeovers.

So in a world in which (1) short-term management can result in short-term bumps in profits and earnings, and (2) such earnings and profits are indistinguishable (or costly to distinguish) from those coming from long-term-oriented companies, then (3) the market will be slow in punishing short-term-oriented management.

That is, there will be a lag between the implementation of short-term management and when the chickens come home to roost, in that it may take some time for the capital market to price the shares correctly.

The other side of the story should be told as well: it will often be difficult and costly to distinguish between a company that is showing a low level of short-term profits and earnings because of the costs of implementing a long-term strategy and a company suffering a low level of profits and earnings because of poor management or a failure of strategy. So the share price of the company that is actually being well managed for the long term—but showing no signs of success as of yet—will trade falsely low.

The existence and extent of this lag time between the establishment of a long or short time horizon and the recognition of the costs or benefits thereof in the stock price will depend on a number of factors. The most prominent of these will be how obvious the strategy is to investors in the market. The more obvious the strategy, the more efficient the capital markets will be in "pricing" the securities issued by the company. If a company that is pursuing a short-term strategy is able to camouflage it as a long-term strategy, the stock price will be falsely inflated until the strategy becomes sufficiently clear to the investing public that they recognize that it is overpriced. Only then will the share price fall to a level that correctly reflects the company's value.

Most investors will not invest the time to distinguish between the long-term companies that are not yet making money and the companies that are simply floundering. Instead, they will look toward companies that are showing profits and earnings. The problem there is that some of these—investors will assume—are realizing the benefits of successful long-term strategies and some are simply exchanging long-term benefits for short-term profits at the cost of the company's long-term prospects.

SOPHISTICATED INVESTORS IN A UNINFORMED MARKET

Note that nothing I have said so far will be unknown to sophisticated investors.

They know that earnings and profits in the short term do not necessarily translate into long-term success. They also know that a failure to show short-term earnings does not necessarily mean that the company is destined to fail. But they also know that it is costly to figure out which is which, and what counts to them is the value of their portfolio as a whole over time, not the profits from a single investment.

So in maximizing the value of their portfolio, sophisticated investors face a variety of choices. If such an investor has a short-term focus, perhaps because their own time horizon is short due to imminent retirement or the like, then they have no incentive to try to pick the long-term successes and hold for the long term. They will, rather, look for companies whose stocks will pay off in the short term, whether such pay-off comes as a result of short-term strategies with long-term consequences or companies that are realizing the pay-offs of long-term strategies.

As for long-term investors—individuals planning for retirement years in the future, or investment funds that hold accounts for such people—one might expect that they would tend to "buy and hold" investments in companies that appear to be strong for the long term, even if short- term earnings are disappointing or foregone. That is certainly true for some long-term investors, but certainly not all. Such long-term investors, whether individuals or institutions, face a choice: they can (1) try to identify companies that have successful long-term strategies but have undervalued stock at present; or (2) identify companies with high earnings and profits in the short term. Some of the latter group will be truly successful companies; some will be companies that are utilizing strategies to emphasize short-term gain at the expense of long-term gain.

Both strategies are in fact followed by long-term investors. Both have their risks and costs. Under the first strategy, the risk is that the investments chosen will not in fact pay off, and the major cost is the expense of discovering such undervalued companies. The cost of research under the second strategy is much less—an investor need only look at the numbers. The risk of the second strategy is holding too long. If a stock's inflated value becomes obvious to the market, the stock price will plummet. In other words, the key to the second strategy is timing. Get in, ride the wave, and get out before it crashes down. Then take your money and find another investment in the short-term market.

Note a key fact about the second strategy: A short-term investment strategy will become even more successful if the investor can control the timing of the investment's withdrawal, to capture as many of the short-term gains as possible before the inevitable downgrade in stock price.

Most investors do not have any way to do that. They can only try to stay ahead of the curve by trading often and quickly, usually on the slightest sign of downturn in a stock. This makes the market as a whole more volatile, since small upticks in stock price will attract a host of short-termers looking for a place to put short-term money and small downturns will cause many short-termers to flee in fear that the small downturn is the beginning of something worse. But such a strategy is highly risky, and unlikely to maximize gains over time (witness that very few mutual funds outperform index funds over time).

MAKING A SHORT-TERM STRATEGY WORK IN AN UNINFORMED MARKET

What if an investor *could* time their investments? The gains from the short-term strategy could be immense. The long-term value of their portfolios would be the summation of a series of above-market, short-term gains. And the strategy could be maintained as long as there are enough investment opportunities available that the money investors pull out of one company can find a place to land elsewhere.

But how could such timing be accomplished?

Let us imagine a situation in which investors—whether individual or institutional—can affect the time horizon of a company, to accelerate earnings and capture as much of the company's future value as possible in the near term. Let us also imagine a situation where they could keep that information camouflaged from the market generally. How would they do that? The answer is by taking over management of the company or by buying up enough stock in a company that the management is forced to listen to you.

Obviously, such a tactic would be available only to investors with significant capital to invest. But if investors are successful in doing so—buying off management or buying off companies— then the company can be caused to do the things that shift future company value to the present. For example, the company can buy back stock, increasing immediate returns to investors; pay management exorbitant compensation, in effect taking present and future earnings of the company as individual compensation; sell off portions of the company for cash, distributing the cash as a dividend; they can leverage the company highly, multiplying the return on equity at the cost of increased risk for the firm in the long term.

Moreover, while the investors themselves are managing the company in such a way, they need not make the true implications of their decisions clear to the investing public.

One mechanism for taking control of companies in this way is private equity. In fact, private equity funds are *defined* as this: they take over companies and manage them as private corporations, free from many of the reporting obligations required of public companies. (Private equity as an investment sector earned almost 36% in 2005, 24% in 2004, and 23% in 2003.) Also, certain hedge funds have such large amounts of capital to throw around that they may be able to get similar results from management without actually taking over the companies.

And note that many managers may *want* to maximize short-term earnings at the expense of the long term. Managers find it advantageous to use short-term strategies as well. It is much easier to meet next quarter's Wall Street earnings expectations, by hook or by crook, than it is to guide a company toward a long-term goal. And if their compensation consists primarily of stock and stock options, then they have incentives to consider themselves investors rather than managers. When this is true, then they can manipulate the company using the strategies described above to maximize their own short-term gain at the expense of the long-term health of the company, and time their departure before the company falls back to earth.

WHAT TO EXPECT IN A SHORT-TERM MARKET

So that's the story of how short-term-oriented investors could collude with or become short-term-oriented management to cause businesses to manage for the short term without being punished by the market in the short term. Such a strategy will hurt the company in the long term and impose external costs onto company stakeholders with long-term interests, as well as society and the economy in general. But such costs will not be borne in the short term by the investors or managers. As long as they "get out" in time, they will be able to enjoy above-market returns in the meantime. And as long as they can continue to find companies that are susceptible to the same strategy, they can maintain above-market returns for the duration. But of course such returns are not truly a reflection of anything other than being a winner in a zero-sum game. The returns are not a reflection of excellent management, or product innovation, or the creation of value. They are only, in economists' terminology, the "extraction of rents," the shifting of financial gain from someone who is losing at least as much. The fact that those who are losing live in the future does not make the losses any less real.

One last thing to recognize: in a market where companies are being increasingly managed for the short term, the typical "Main Street" investor will not stay in the dark forever. Investors who do not have the access or capital of the hedge funds and private equity funds will eventually recognize what is happening. So they, too, will start investing with a view toward the short term, and be extremely sensitive to downticks in stock price that might be signs of a more serious downturn. This will in turn make the market as a whole more volatile. And as volatility increases, the entire market will become less secure. More and more investors will either lose their shirts or simply leave the market and put their money elsewhere. And, eventually, the costs of short-term management will be such that the entire economy will suffer. The chickens will eventually come home to roost.

If you have read a newspaper over the last year or so, this story should sound familiar. ■

ENDNOTES

1 See http://www.huffingtonpost.com/2009/03/12/jim-cramer-on-daily-show-_n_174503.html.

2 See Dent, George W., Jr. 2009. *Stakeholder Governance: A Bad Idea Getting Worse,* 58 Case W. Res. L Rev. ___, ___ (denying a problem with short-termism exists).

3 Mitchell, Lawrence E.. 2007. *The Speculation Economy: How Finance Triumphed Over Industry* 277-78 .

4 Kuttner, Robert. 2007. *The Squandering of America* 144.

5 Mitchell, supra, at 1.

6 Id.

Not Just for Profit:

Emerging Alternatives to the Shareholder-Centric Model[1]

MARJORIE KELLY
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WHEN MOHAMMAD YUNUS AND THE Grameen Bank received the Nobel Peace Prize in October 2006, one endeavor lifted into the limelight was Grameen Danone Foods. This was a path-breaking collaborative enterprise, launched that year as a 50/50 joint venture between Groupe Danone—the US$16 billion multinational yogurt maker—and the Grameen companies Yunus had cofounded. Yunus called the joint venture a "social business," which he said could be a pioneering new model for a more humane form of capitalism. As he explained in his book *Creating a World Without Poverty: Social Business and the Future of Capitalism* (Yunus 2007), a social business is a profit-making company driven by a larger mission. It carries the energy and entrepreneurship of the private sector, raises capital through the market economy, and deals with "products, services, customers, markets, expenses, and revenues—but with the profit-maximization principle replaced by the social-benefit principle."

The mission of Grameen Danone Foods is to bring affordable nutrition to malnourished children in Bangladesh with a fortified yogurt, under the brand name "Shokti Doi" (which means "yogurt for power" in Bengali, the country's language). It began in October 2005, when Franck Riboud, the CEO of Groupe Danone, took Yunus to lunch in Paris. "We would like to find ways to help feed the poor," said Riboud. Yunus suggested the revolutionary joint venture and proposed that a new structure be invented for it, a hybrid between nonprofit and for-profit.

Like a conventional business, Grameen Danone must recover its full costs from operations. Yet, like a non-profit, it is driven by a cause rather than by profit. If all goes well, investors will receive only a token 1 percent annual dividend, with all other profits being plowed back into the business. The venture's primary aim is to create social benefits for those whose lives the company touches. For example, the first Grameen Danone factory, which opened in November 2006, was deliberately built small, as a prototype for more community-based plants that would provide jobs across Bangladesh. "It's just a tiny little plant, but it has a big message," said Yunus in a speech to Global Alliance for Improved Nutrition, the nonprofit organization brought in to monitor the company's impact on local health. "While we make money, we can also do good." Riboud adds, "I'm deeply convinced that [humanity's] future relies on our ability to explore and invent new business models and new types of business corporations."

Yunus and Riboud are not alone in seeing the critical importance of instilling a purpose other than short-term profits at the core of corporate designs. In a celebrated January 2008 speech at the World Economic Forum, Bill Gates called for a new form of "creative capitalism." And around the world—largely beneath the radar of mainstream awareness—alternative designs are being developed that, like Grameen Danone, seamlessly blend a central social mission with profitable operation. These include the burgeoning microfinance industry, emerging hybrids like nonprofit venture capital firms, new architectures such as Google.org that embody "for-profit philanthropy," dual-class shareholding structures, employee-owned companies, the foundation-owned corporations of northern Europe, and a variety of cooperatives on every continent. These models vary enormously in size and mission, but they are significant for the same reason: together, they represent an evolutionary step in the development of corporate structure.

THE SOUL OF A NEW DESIGN

For years, critics of the corporation have argued that the prevailing design of publicly held corporations is innately flawed. That design involves a board that is elected by shareholders—with votes allocated proportionately to the number of shares held—whose members then appoint a semi-autonomous CEO as the shareholders' agent, who in turn delegates authority down through the ranks. In many ways, this has been a highly effective model. The "managerial hierarchy" structure, as corporate historian Alfred D. Chandler, Jr. called it, has accomplished more in a short time than any other form the world has known.

But this shareholder-centric model has also contributed over the years to what former Citigroup CEO John Reed has called the "iron triangle of short-term pressures,"—hedge funds, stock options, and stock analysts—that keeps companies narrowly focused on quarterly profits..

The financial meltdown of 2008 was a direct result of the pursuit of immediate profit by investment bankers and mortgage brokers who disregarded the impact of their actions on customers, on the larger economy, and indeed on stockholders and the company itself in the long term. Those who wanted to operate with integrity found it difficult. They were constrained by a corporate design that reinforced the need to "make the numbers" by any means possible—a design that bestowed the greatest governance power on short-term shareholders, the stakeholders with the least interest in long-term performance or the external community. Conventional methods for preventing abuses, such as regulation and criminalizing egregious behavior, are only partially effective. In the long run, the best way to get to the root of the problem will be for corporate ownership and governance design itself to evolve.

If the idea of creating alternative forms of corporate ownership and governance is unfamiliar in conversations about the meltdown (or other business abuses), it's because the prevailing form of corporate design is generally taken as a given. Under the law of most countries, it's difficult for corporations to adopt any other form. But against the odds, tender green shoots of new company designs are emerging today, and existing alternatives are being adapted. Some emerging models are as likely to show profitability as more conventional companies, and all are more adept at pursuing goals that conventional for-profit companies usually fail to reach: treating customers fairly, protecting the environment, creating a healthy workplace, and supporting the communities in which they operate.

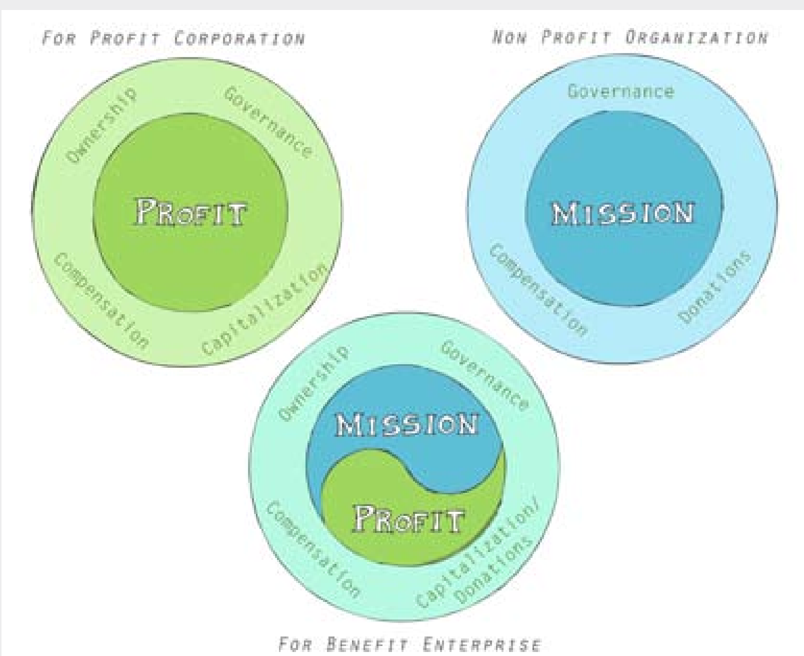
Richard Nelson, an economics professor at Columbia University who co-founded the field of evolutionary economics, observes that social systems evolve because of two kinds of innovation: advances in physical technologies (such as new environmental and energy technologies), and advances in social technologies (such as new forms of organization). While a good deal of public attention is focused on physical technologies, social technologies are equally as important. The two must co-evolve.

As these two types of innovation influence each other, the governance models that emerge—such as microfinance-related structures—take their place alongside older, more established alternative models, such as cooperatives, employee-owned firms, and government-sponsored enterprises. These designs can be thought of as emergent new organizational species, occupying a new sector of society that is a greenhouse of design experimentation in which the future of our economy may be growing.

One helpful way of thinking about these designs is as representing a hybrid between the traditional for-profit archetype, which has profit at its nucleus, and the traditional nonprofit archetype, which has social mission at its nucleus. This type of hybrid has been dubbed the "for-benefit enterprise" by Heerad Sabeti, CEO of the TransForms Corporation—a North Carolina-based manufacturer of wall decorations with about $2 million in revenues, which routinely employs people with disabilities and invests heavily in developing its workforce. Sabeti is one of a number of people who have begun to explore the parameters of this new archetype. (Another source of exploration is the Corporation 20/20 initiative, organized by Allen White and me at the Tellus Institute in Boston.) In a synthesis of the best of this thinking, we can conceive of the new type of organization with a blended purpose at the core: serving a living mission and making a profit in the process. The essential framework of such a company—its ownership, governance, capitalization, and compensation structures—is designed to support this dual mission. And it is this design that enables companies to escape the pressure to maximize short-term profits and instead to fulfill a more fundamental purpose of economic activity: to meet human needs and be of benefit to life.

Future experimentation is inevitable: the fully realized for-benefit corporate design—with all the right elements, a design that's capable of replacing the dominant model of today—may not exist yet. We may be entering a new era of design biodiversity, in which different designs serve different functions. Today, at least three broad approaches to for-benefit architecture offer promising models: *Stakeholder-Owned Companies,* which put ownership in the hands of non-financial stakeholders; *Mission-Controlled Companies,* which separate ownership and profits from control and organizational direction; and *Public-Private Hybrids,* where profit-driven and mission-driven design elements are combined to create unique structures.

THREE ORGANIZATIONAL ARCHTYPES



The top circles represent old organizational models, not flexible enough for our current era. The bottom circle shows an alternative: the "for-benefit enterprise," where companies have a dual purpose at their core—serving a mission and making a profit—which is supported by structural aspects of enterprise design, such as ownership, governance, capitalization, and compensation.

ILLUSTRATION BY NICOLE GORKO

STAKEHOLDER-OWNED COMPANIES

The cooperative model of ownership, which dates to the mid-19th century, was conceived as an alternative to the shareholder-based ownership model that developed at roughly the same time. The defining feature of the cooperative model is that these companies are owned and controlled by the members they serve. Members might be customers (as in a credit union), producers (as in a farmers cooperative), homeowners (as in a housing co-op), employees, or the community. (There is some overlap between cooperatives and employee-owned companies, but they are not the same; employees can own corporate shares either through cooperatives or in more conventional business structures through such measures as employee stock ownership plans.)

Cooperatives are a globe-spanning phenomenon, with membership now at 800 million people— more than double the total from three decades ago. In Colombia, SaludCoop provides health care services to a quarter of the population. In Spain, the Mondragon Corporacion Cooperativa is the nation's seventh largest industrial concern. More Americans hold memberships in co-ops than hold stock in the stock market. When they are successful, these stakeholder-owned firms can be extraordinarily long-lived, with remarkable business and social impact: Rabobank in the Netherlands and the Springfield Remanufacturing Corporation in the Missouri Ozarks are two examples of companies that have prospered by drawing on the commitment and engagement of their shareholder-customers and shareholder-employees, respectively.

The success of firms owned and governed by stakeholders shows that, contrary to some economic assumptions, there's nothing innately better about independent shareholders or directors. But stakeholder ownership also has its flaws. Cooperatives have failed to match the growth of shareholder-owned companies because they lack access to capital (laws governing cooperatives often put restrictions on capital returns), and they can fail to retain leaders who perceive less chance of accumulating personal wealth. On the other hand, when employee ownership is matched with involvement, businesses can achieve results that would be considered near-impossible in conventional companies.

The Cooperative Regions of Organic Producers Pool (CROPP), better known by its brand name Organic Valley, is a producer-owned marketing cooperative in La Farge, Wisc. CROPP is owned by the 1,200 organic family farms that produce the dairy, eggs, and meat it distributes. The company's mission is to save the family farm, which means paying as much as possible to farmers. "We don't have any need for profits much over 2 percent," says CEO George Siemon. "We'd just pay taxes on it. We'd rather give it to the farmers." Though growth has slowed in recent months, for years the company grew 30 to 40 percent per year. With 2007 revenues of $433 million, Organic Valley stewards one of the nation's four largest organic brands.

Similarly, the John Lewis Partnership PLC, with £6.8 billion (about US$10 billion) in revenues in 2007, has a stated purpose of serving the happiness of its employee-partners. It is the largest department store chain in the U.K., and also owns 200 Waitrose supermarkets. It is 100 percent owned by its 69,000 staff members, among whom most profits are shared each year. It is overseen by an unusual bicameral governance structure. The company has a traditional board of directors as well as a second employee-based governing body, the partnership council, directly elected by employees. The partnership council in turn elects five of the twelve board members. The council also influences policy and holds management to account, since it has the formal power to dismiss the chairman.

MISSION-CONTROLLED COMPANIES

A little-appreciated but powerful for-benefit model can be found among companies that manage to be publicly traded while keeping control in mission-oriented hands. Take Interface Inc., for example. This Fortune 1000 flooring company, with 2007 revenues of $1.1 billion, is well on its way to meeting its ambitious 2008 pledge of "Mission Zero by 2020"—a pledge to have zero negative impact on the environment within 12 years. This means eliminating waste and switching entirely to renewable energy, as part of the company's larger vision of being the first company that, as founder-CEO Ray Anderson puts it, "shows the entire industrial world what sustainability is in all its dimensions."

Other publicly traded companies have tried to make this kind of long-term commitment, but have had to soften the goal through the ups and downs of the stock market. What supports Interface's mission is a rarely mentioned but vital element in its social architecture: a dual-class share structure that puts super-voting shares in the hands of Anderson and a few other top executives, giving them control of 72 percent of votes for the board, although they own far less than a majority of publicly traded shares. Super-voting shares are generally unavailable to the public, which insulates the company from hostile takeovers. In effect, it allows Interface to be a mission-controlled enterprise, one whose governance structure reflects both the need for ongoing sufficient profit and a broader social priority.

Mission control allows capital to trade freely, even as it ensures that the mission is not for sale. It allows leaders to focus the company so that mission becomes the focal point while profits are energetically pursued.

There are other companies with publicly traded stock and revenues over $1 billion that are similarly mission controlled. They include the family-controlled *New York Times*, with its mission of serving an informed electorate; foundation-controlled

Novo Nordisk, a Danish pharmaceutical company with a mission of defeating diabetes; and trust-controlled Grupo Nueva SA, headquartered in Chile, with a mission of contributing to a sustainable Latin America. Perhaps the most notable recent example of mission-controlled architecture is Google, which adopted a two-tier stock configuration, vesting power with its founders, when it went public in 2004.

In the best of these designs, the mission's control of voting shares is strengthened by an explicit commitment to mission in the company charter and in the design of governance procedures. Novo Nordisk, for example, has adopted an ambitious charter that spells out the company's values and commitments, including a commitment to ensuring that all products and services "make a significant difference in improving the way people live and work." Each year the company board must report to the foundation board on how it is ensuring that operations are "economically viable, environmentally sound, and socially fair." The foundation board includes an electrician, scientists, a physician, and a lab technician, so that participants represent many relevant points of view. Without design elements like these that keep mission in focus, super-voting share structures run the risk of creating company monarchs unanswerable to anything but their own whims—which may or may not remain benign over the long run.

Mission-control architecture can offer a solution to the challenge that socially responsible companies face as they struggle to keep social mission alive after founders depart or sell their shares. It is rarely sustainable for the mission of a company to be embodied in the personality of a single individual, no matter how charismatic or well-intentioned that individual is. Research shows that once founders depart, company mission often shifts—and in the absence of thoughtful for-benefit design, the pressure of mainstream cultural norms and financial practice makes it easiest to revert to short-term results as the primary goal.

One of the companies that is most explicit in using design to achieve a mission is the Upstream 21 Corporation, a socially responsible holding company launched by the social investing firm Portfolio 21 Investments in Portland, Oregon. This holding company was set up explicitly to buy local companies, in order to build natural, social, and economic capital within the region. Oregon stakeholder law says directors *may* consider the interests of many stakeholders, not just stockholders, in making decisions, and Upstream's articles of incorporation adopt language saying directors *shall* do so. The Upstream design also reconfigures voting rights, giving greater power to hands-on owners (including employees) and diminished power to absentee owners.

The "directors' duty" aspect of this design has since been replicated by more than 130 companies signing on to become B corporations, or beneficial corporations. This model is being promoted by Jay Coen Gilbert and his colleagues at the non-profit B Lab in Philadelphia, who aim to create a unified marketing presence and certification process for B Corporations. Unfortunately, they did not replicate Upstream's redesign of voting rights in their model. Because virtually all B Corporations today are founder controlled, these firms may be vulnerable to losing their mission when the founders depart. But as the B Corporation model becomes more widely adopted, a community of practice could emerge—similar to the communities of employee-owned companies and cooperatives, with their networks of attorneys and consultants—that could help in the ongoing evolution of this promising new model.

PUBLIC-PRIVATE HYBRIDS

A third school of for-benefit design involves company architectures that deliberately blur the lines between for-profit and non-profit modes of operation—Grameen Danone. One powerful model here is being termed "for-profit philanthropy," and it is famously embodied by Google.org, a boundary-spanning entity created by Google. Google.org currently manages a philanthropic budget of $2 billion; the amount is based on Google's initial public offering, which announced the company's intention to contribute 1 percent of equity and 1 percent of profits to charity.

As Brooklyn Law School Professor Dana Brakman Reiser observed in a recent paper, Google.org is not a traditional foundation but a division of Google, standing alongside the engineering, sales, and finance functions, yet tasked with addressing climate change, disease pandemics, and poverty. By eschewing tax-exempt status, it gains the running room to combine investments with grants as it pursues its ambitious goals—drawing fully on Google's staff, technology, and products in the process. As Reiser wrote, "Google.org's use of an integrated for-profit division inaugurates a new model: 'for-profit philanthropy.'" The director of Google.org is Larry Brilliant, known both for his business acumen (he co-founded the Whole Earth 'Lectric Link [WELL] computer network) and for his medical philanthropy (he was a primary figure in the World Health Organization's eradication of smallpox and cofounder of Seva, a foundation that brought eyesight to more than 2 million blind people).

Another cross-sector governance model involves nonprofit companies that create for-profit subsidiaries—being deemed "social enterprises." The Great Neighborhoods! Development Corporation (GNDC) in Minneapolis—where I serve on the board—has ushered in a renaissance in the once-blighted Phillips neighborhood by driving out disreputable bars, drug dealers, and prostitutes and bringing in a business incubator, health clinic, grocery store, and retail shops. Although GNDC is a nonprofit organization, its real estate projects are designed to operate in the black. "We're in the business of changing the lives of the poor, and we're using real estate business development to do it," says Chief Executive Officer Theresa Carr.

Yet another model in the hybrid category would be "nonprofit venture capital" funds, such as the Acumen Fund, which raises charitable funds to serve the poor but takes an investing rather than grant-making approach, offering equity and loans to both for-profit and non-profit organizations that deliver affordable housing, energy, and clean water in South Asia and Africa.

PRINCIPLES BEYOND PROPERTY

There is now enough experience with these three basic schools of design—Stakeholder-Owned Companies, Mission-Controlled Companies, and Public-Private Hybrids—to begin to identify some broad principles of design at work. Deeply embedded in them is the aim of delivering human or ecological benefits. A company might be a producer cooperative designed to save the family farm, a pharmaceutical company aiming to defeat disease, an employee-owned firm making the workplace into a community, a microfinance institution seeking to end poverty, a development corporation revitalizing the inner city, or a public company laying a path to sustainability. In tangible ways, all aim to benefit life. Social issues are not relegated to an ethics office in room 201 or left to the whims of particular leaders, however noble they may be.

All the successful examples embody a view of enterprises as living systems. Most economists and law professors still view companies primarily as pieces of *property,* owned through their shares. But for-benefit design starts with the assumption that companies are organically evolving entities, living social systems—in other words, human communities. And their design reflects that view.

These designs also reflect the added complexity of the for-benefit sphere, and the need to encourage innovation while safeguarding against potential abuses. The track record in the microfinance sector shows why safeguards are needed, and why trumpeting good intentions, in itself, isn't enough. The original Grameen Bank business model pioneered by Mohammad Yunus —alleviating poverty by lending small amounts of money to micro-entrepreneurs who then become depositors, allowing communities to recirculate capital—led to dramatic success in Bangladesh. It also inspired an international microfinance industry, which today has its own rating agencies, consultants, conferences, institutes, and billions upon billions of dollars in international lending. Central Asia alone is now home to more than 1,000 microfinance institutions. In India, the number of microfinance clients grew ten-fold over four years to surpass 10 million at the end of 2007. As this industry grew, the mission of the original model was sometimes lost. New microfinance banks dispensed with critical governance features, such as training local lending officers to work closely with teams of borrowers. Instead, they simply lent at the highest rates possible. The result has been a new set of abuses. Banco Compartamos SA – a Mexican microbank portraying itself as a gentler lender to the poor—hugely enriched its initial investors when it went public in 2007. Yet it reportedly made that fortune in part by charging almost 100 percent annual interest rates to illiterate Mexican mothers.

Some may wonder if these alternative designs are intended to promote or lead to socialism, but in fact the concept of private ownership is deeply intrinsic to them. Instead of doing away with private ownership, these firms redesign it. It has been clear since the days of Adolf Berle and Gardiner Means—who published their breakthrough book, *The Modern Corporation and Private Property,* in 1932—that business ownership is often separated from its most vital element, control. These designs go further by concentrating control in a deliberately chosen group, selected as stewards of the firm's living mission. Ownership shares can be bought and sold like property, but controlling shares represent a living essence that is not for sale—or for sale only under restricted conditions.

In the case of Grupo Nueva, control is vested in the VIVA Trust, which is charged in perpetuity with protecting the vision and values of the firm. In describing the value of the trust, founder Stephan Schmidheiny said, "Now there is an ownership structure that is permanent, reliable, and committed to the long term, and that will not be a victim of speculation or personal whims, or the lack of preparedness of a successor; all this reduces risks for the investor."

In other cases, mission is preserved through governance designs that feature non-financial stakeholders. At Organic Valley, for example, governance by a central board is supplemented by a network of regional farmer pools, each with staff support. In still other cases, for instance, with cooperatives, governance design is shaped by laws that stipulate a policy of one person, one vote, as contrasted with one share, one vote. Diversity is the hallmark of these governance innovations. For if capital is the only group with a seat at the table, capital's view of the corporation is likely to prevail: the company will be seen as a piece of property whose worth is measured by stock price.

MEETING THE MAINSTREAM

Leaders of traditional firms may recognize the opportunities in these new forms. They can achieve a broader array of goals by adopting a for-profit philanthropic division, as Google has, or attempt a social business joint venture, along the lines of Grameen Danone Foods. They can rapidly improve their operational excellence through the engagement inherent in employee ownership, as founder and CEO Jack Stack has at Springfield Remanufacturing. A few may even attempt to transition to a mission-controlled design, like that employed by Interface.

Such models will have to overcome long-standing, deeply imbedded cultural traditions and legal imperatives. But as nascent alternatives to the conventional structure quietly succeed, options may continue to open in coming years, particularly among business startups. "It is the entrepreneurial spirit that has always led the evolution from one age to the next," said Mike Thomas, a former executive with Granite Construction Company who is now a senior partner at the Monterey Institute for Social Architecture in Monterey, California.

In certain cases, alternative enterprises best serve their social mission by keeping profits low. On the other hand, some alternative models can be very economically competitive. Studies have shown, for example, that employee-owned firms modestly outperform their peers, and that when these companies have high employee involvement, they do even better. In a 2002 paper, Steen Thomsen and Caspar Rose of the Copenhagen Business School found that foundation-owned firms—common throughout northern Europe—perform no worse and even slightly better than traditional firms. The critical difference is that these companies do not set making money apart from other goals; there is no false choice between making money and fulfilling other missions. The design of the company is aimed at accomplishing multiple goals at once.

We live in an age when short-term pressures have allowed speculation to overtake the more traditional, human functions of business. Alternatively designed companies offer important lessons in how corporate ownership and governance can evolve differently. And they're important in their own right as well, for they are likely to prove better adapted to the cultural and ecological demands of the 21st century than the industrial age models they might one day replace. Such businesses may seem like anomalies today. But they more closely reflect the priorities that engendered the longest-lasting businesses throughout human history. ■

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Markets at Risk:

The Limits of Modern Portfolio Theory

STEVE LYDENBERG
DOMINI SOCIAL INVESTMENTS

IN THE FACE OF ONE OF THE GREATEST financial and economic crises of the past 100 years, legislators and regulators are deciding what new steps need to be taken to keep the abuses that have provoked such situations from recurring. They are, understandably, focusing on the supply side: the host of new, highly risky financial products and practices around the world that need to be reined in and brought under control.

Unfortunately, not as much attention is directed at the demand side: the apparently insatiable demand for risky products coming from our largest and most sophisticated institutional investors. Those demanding these risky products have been as responsible for their spread around the world as have those providing the supply. Regulating that demand—tempering it, restraining it, controlling it—is as likely to prevent the recurrence of future financial crises as is trying to prevent super-smart money managers from finding fancy ways to package risk in today's marketplace.

Not more than forty or fifty years ago this demand was easily controlled. Fiduciaries—the largest institutional investors of today: pension funds, mutual funds, and trust officers—were by and large limited in their abilities to invest in stocks because they were too risky, not to mention mortgage-backed securities, synthetic collateralized debt obligations, credit default swaps, double-barrier foreign exchange options and their like. A true fiduciary did not take risks with other people's money. The security and modest returns from buying and holding triple-A bonds to maturity were more than enough reward.

Modern Portfolio Theory, or MPT as it is most often referred to, has been a crucial element in the unleashing of this recent wave of demand for risk. It may not be difficult to understand how MPT, with its sophistication, elegance, and complexities, has succeeded in persuading investors that large risks can be controlled. Putting the genie of MPT back in the bottle, however, will be a more difficult task. Fixing MPT, correcting its flaws, is not sufficient to this task. We will need an entirely new theory to underpin investment practice if we hope to tame this powerful force that has been set free in the financial world.

Even the most casual, unsophisticated observer can intuitively understand that financially risky products are at the heart of today's financial crisis. It is easy to see that it was a $450 billion bet on credit default swaps that brought down AIG, the largest insurance company in the world; that highly risky subprime mortgages broke the back of Washington Mutual, one of the fast growing regional banks in the United States; that out-of-control hedge managers bankrupted Bear Stearns; and that highly leveraged real estate deals contributed to the downfall of Lehman Brothers. Risk-taking has devastated financial institutions around the world and brought whole national economies—Iceland is the most dramatic example—to the brink of fiscal collapse.

These risky products purveyed by reckless financial institutions existed in part because there was a willing market—and institutional investors bound by fiduciary principles of prudence to their beneficiaries were part and parcel of that market. These institutions are among the largest investors in the world. Pension funds around the world control some $25 trillion in assets. (Watson Wyatt 2008) In the United States, endowments of universities alone exceeded $400 billion in assets as of 2008. (NACUBO 2009) Some of the most technically expert investment professionals in the world clearly thought the investments they were making were prudent, and the reason they thought so was MPT.

To understand the front-page headlines about today's financial crises we must step behind the scenes to understand some of those fundamental precepts of MPT that have been so influential. Although a full exposition of MPT—its origins, its primary elements, and the debates about its various hypotheses—is not attempted here, the following highlights a number of its most important contentions and theories and examines their implications for investment practices today.

ORIGINS OF MODERN PORTFOLIO THEORY

The progenitors of MPT were academics who, starting in the 1950s, set out to solve a relatively simple problem: how to justify investing in risky stocks. In the late 19th and early 20th centuries, stocks were an unregulated, highly risky, speculative investment prone to boom and bust—and consequently were off limits to prudent investors. The risks of investing in stocks were made painfully clear during the crash of 1929 when the stock market lost almost 90% of its value over three years.

Initial attempts to legitimize investing in the stock market were made during the depths of the Great Depression. Among the most important were increased transparency and government regulation. The Securities and Exchange Commission was created in 1933 and 1934 and directed to oversee the stock markets. Companies were, for the first time, required to disclose audited financial statements. Also in 1934, Benjamin Graham and David Dodd published their still popular classic *Securities Analysis: Principles and Techniques,* which laid out convincingly principles for purchasing stocks at reasonable prices. (Mitchell forthcoming)

This combination of regulatory initiatives and academic advice helped legitimize investing in stocks, but essentially wasn't sufficient to justify fiduciaries taking the plunge into the equities markets because it provided no *theoretical* reason why stocks should be viewed as safe.

It wasn't until the mid-1950s, when the stock market once again reached its 1929 highs, that academics tackled the task of developing a *theoretical* rationale for the "prudent man" to invest in stocks. MPT provided that theoretical framework. (Bernstein 2005) It demonstrated that the risks inherent in investing in stocks could be measured and controlled at a portfolio level during normal market conditions.

The origins of MPT can be traced to the seminal work of Harry Markowitz. In a 1952 article in the *Journal of Finance*, Markowitz pioneered the concept of controlling risk at a portfolio level through diversification. Markowitz's work was revolutionary because it viewed risk as a portfolio problem, not a problem in individual security selection. Investing in countercyclical stocks was the key to controlling risk. If companies involved in home repair thrive when those that build new houses struggle, then a portfolio of the stocks of both companies will be less risky than investments in either company alone. Investing in one risky stock might be unwise, but investing in two risky stocks—each risky in its own way—can be prudent. (Markowitz 1952, 1959)

Increasing the opportunities to invest in risky securities is crucial to investment managers today because the greater the risks the greater the potential rewards. By diversifying risk throughout a portfolio, managers can achieve greater portfolio returns without taking greater overall portfolio risks. Diversification techniques are what Peter Bernstein calls "the closest thing to a free lunch" that there is in investing. (Bernstein 2005)

In the 1960s Eugene Fama, Sidney Alexander, and others developed a second mainstay of MPT: the efficient market hypothesis. In its various forms this hypothesis asserts that the stock market essentially reflects all available information at any given time. This implies that stocks are appropriately—or "efficiently"—priced. In addition, this theory implies that a money manager cannot beat the market—at least not all the time—because the market knows more and is "smarter" than any one individual. (Fama 1970)

A crucial variation on this theme was necessary as well to account for the fact that markets bounce around irrationally day to day. MPT concedes that stocks can be temporarily mispriced. These momentary lapses in the otherwise efficient markets give better-informed investors an opportunity to take advantage of temporary market anomalies and, brief as these anomalies might be, to buy or sell stocks before they revert to their true mean.

Simultaneously, William Sharpe, James Tobin and others were developing the Capital Asset Pricing Model, which provides a means of measuring expected returns on any given investment of a particular level of risk. This formula—and it is an algebraic formula—allows investors to measure the success of their investments. That is to say, it allows them to assess whether they have achieved an appropriate level of return for the level of risk they have taken. (Sharpe 1970)

Crucial to this theory is the definition of risk as the volatility of a stock's returns relative to the market. A stock is risky if its price goes up or down more than the price of its peers. This simple, narrow definition has led to the creation of innumerable benchmarks that define the markets against which investment success can be measured. More important, once this definition of success is accepted, it leads to the logical conclusion that the duty—the fiduciary duty—of an investor is to "beat the market," that is, to achieve returns that are better than a benchmark given comparable levels of risk—or at least, to match the market's performance while minimizing expenses.

The final piece of the MPT theory was provided by Fischer Black and Myron Scholes when in 1973 they developed the formula—the Black-Scholes Model—to price options and other derivatives. This formula is crucial because it enabled investors to use derivatives in their portfolios for hedging—and hedging is the simplest means to control risk. This model made risk control, if not necessarily child's play for mere mortals, at least child's play for the highly quantitative mathematicians and scientists hired by Wall Street to show institutional investors how risk can be controlled. Derivatives are viewed as so foolproof a method of controlling risk that they are often referred to as "insurance." (Black and Scholes 1973)

MODERN PORTFOLIO THEORY IN PRACTICE

Thus, all the elements of MPT were effectively in place by the mid-1970s, but it took some twenty years for its basic precepts to be widely disseminated and accepted among institutional investors. The conservative investor of the 1970s and 1980s, who had been told time and time again that one of the primary duties of a fiduciary was to avoid undue risk initially greeted MPT's brilliant academic proponents with doubt and skepticism. (Bernstein 2007)

The tide turned gradually in the 1980s and early 1990s, as the proponents of this theory received increasingly widespread recognition—many were eventually awarded a Nobel Prize in Economics[1]—and as the technology and practical tools for measuring and controlling risk in investment portfolios were developed. But it wasn't until the late 1990s that the floodgates truly opened and fiduciaries in charge of institutional investments embraced MPT wholesale.

Not only did MPT free fiduciaries to invest in blue-chip stocks formerly deemed excessively risky, but it has further led to the embrace of the even more risky stocks of small firms and in the stocks on the exchanges of emerging markets around the world. Other asset classes, whatever their apparent risk, have also become fair game. Private equity, hedge funds, real estate, commodities, currencies—virtually any investment for which there is a market—are now not only available to fiduciaries, but frequently promoted as a necessary investment if they are to keep up with their peers and "beat the market." Previously, the thought of investing in these asset classes was inconceivable—they were seen as reckless and imprudent—now they are a necessary tool for the sophisticated investor.

Once investors accept these four principles of MPT—1) that greater returns come from securities with greater risks; 2) that the risks of individual securities can be diversified away at the portfolio level; 3) that returns are most meaningfully measured against market benchmarks; and 4) that derivatives can be meaningfully priced—then fiduciaries are virtually forced to seek out risky products in order to maximize their returns relative to their peers. That is why MPT has changed the face of investment. That is why investing today inevitably and dramatically increases the demand for risky products in the financial markets.

LIMITATIONS OF MODERN PORTFOLIO THEORY

Despite its current wide acceptance in the marketplace, MPT has severe limitations that are recognized by many mainstream investors. Here, for example, is what Gao Xiqing, president of the China Investment Corporation, one of the largest sovereign wealth funds in the world with some $200 billion under management has to say about derivatives—one of the keystones of MPT. When James Fallows, interviewing him for *The Atlantic*, asked what he thought about these risky products, he answered:.

"If you look at every one of these [derivative] products, they make sense. But in aggregate, they are bullshit. They are crap. They serve to cheat people." (Fallows 2008)

This is a remarkably concise statement of three crucial and somewhat surprising points. First is the recognition that MPT when applied "locally"—that is, at the portfolio level (it is, after all, called Modern *Portfolio* Theory)—works. The second assertion, however, is counterintuitive: when the tools of MPT are widely used—that is to say, when these theories are put *systematically* into practice—they break down. Not only do these tools break down, but they can have a destructive impact on financial markets as a whole.

The third assertion is even more surprising. When Xiqing says derivatives "cheat" people, I believe he means that those who sell these products to institutional investors know full well that they don't work if everyone uses them. They are not quite Ponzi schemes. They are not outright fraud. They are not illegal. But at crucial times they are ineffective, unreliable, and ultimately dangerous.

- The assertion that the specifics of MPT when applied generally are dangerous can be put several different ways.
- The more investors control *portfolio* risks, the greater the *market* risks.
- The more investors control *financial* risks, the greater the *societal and environmental* risks.
- The more investors *hedge* their portfolio bets, the more likely markets are to *go bust.* The more *convinced* investors are that they can control risk, the easier they are to *con.*

While it may seem intuitively self-evident that the more risky products investors demand, the more risky financial markets will become, MPT's assertion that risk can be controlled cannot be casually dismissed. It is not by accident that MPT has become a fundamental and powerful principle of investment today. Its virtues must be fully appreciated and acknowledged before its weaknesses can be accurately analyzed.

MPT needs to be treated with respect not simply because many of its progenitors are Nobel Prize recipients—although that certainly commands respect— but because it has been so widely embraced by so many in powerful positions. Its virtues need to be understood not simply because it has contributed valuable insights to the art of investing, but because it has made many rich. Its weaknesses need to be carefully analyzed not simply because they are apparently inadequately recognized, but because it will take an alternative theory to replace this theory and reform current financial practices. Understanding where MPT is strong and where it is weak is the first step toward building a new theory.

Let's be clear. MPT is an elegant, highly sophisticated set of principles and practices that accomplishes exactly what it sets out to do—control risk at a portfolio level. It can identify and measure risk (defined most simply as volatility) within a portfolio. It can adjust the level of that risk up or down throughout portfolios through a variety of sophisticated techniques. It can compare risks taken to returns achieved and determine if the returns are appropriate to that level of risk. It can measure and compare the capabilities of different managers with different investment styles in achieving these risk-adjusted returns. What's more, it can apply these principles not just to stocks, but to virtually any asset class for which there is a developed market. In its own terms, within the limited boundaries it sets for itself, MPT is a wonderful and undeniable success.[2]

Controlling risk at a portfolio level allows investors to hold an increased number of risky securities. The importance of this concept cannot be overstated. It is the path that leads to greater portfolio returns without greater portfolio risks. It is a theory and a practice that sound too good to be true. And unfortunately, at a market level, that is precisely the case.

Within the context of the financial markets, two things happen when substantial numbers of investors put this theory into practice. The first is that, as the demand for risky products increases, the overall quantity of risky products in the marketplace increases. The dangers of this increase are obscured by the fact that the risk of each portfolio, when viewed individually, is apparently negligible. (In Gao Xiquin's words, "If you look at every one of these products, they make sense.")

At a portfolio level, risk can be diversified away by purchasing securities or asset classes with countercyclical risks; by securitizing and redistributing risky securities to others, as in the case of speculative mortgages or commercial real estate loans; or by hedging against risks through the purchases of derivatives. Hedging in particular is the most elegant and most immediately effective way to deal with risk. That is why the notional value of derivatives in the marketplace stood at $683 trillion as of June 2008. (Bank for International Settlements 2008)

Risky products designed to control risk—and risky debt (or, as it is often referred to in the financial community, "leverage") used to multiply the returns from these risky products—now dominate the investment landscape. When they start to fail, they fail spectacularly—as the current financial crises that have brought the largest, most sophisticated financial institutions in the world to their knees amply demonstrate. ("But in the aggregate, they are bullshit. They are crap.")

A second limitation of MPT is that its definition of risk is purely financial—that is to say, purely related to the price volatility of a security relative to a benchmark index. By limiting the definition of risk to price volatility, MPT ignores the possibility that investments can either pose social and environmental risks or, because reward is the flip side of the risk coin, that investments can create social and environmental benefits.

Addressing this limitation forces us to recognize that the act of investing—the allocation of assets to specific institutions for specific purposes—creates products and services that impact society. This may sound like a self-evident truth, but it is one that is ignored by MPT. When investors pour money into the fossil fuel industry because a skyrocketing price of oil makes these companies momentarily profitable, MPT is of great help in measuring their financial returns versus their financial risks, but its formulas are of no help when it comes to, for example, the risks of climate change. On the flip side—that of measuring rewards—when investors allocate dollars to microlending programs that enhance the abilities of large segments of the world's population who have not previously had access to financial services to take at least tentative steps out of poverty, MPT has no calculus for these benefits to society.

In addition, for every investment made there is not only a potential societal risk and reward, but there is an opportunity cost for which there is no place in MPT's equations. Every dollar invested in oil companies is a dollar not invested in alternative energy. Every decision to invest in the development of high-cost and high-margin drugs to treat the chronic ills of the developed world is a decision not to invest in cures for malaria, sleeping-sickness, tuberculosis, AIDS, and other scourges of the developing world, not to mention vaccines.

Furthermore, MPT's ignorance of the societal and environmental implications of investment decisions also short-circuits debates about government's role in the creation of public goods. By focusing the concept of investment narrowly on market-based returns, MPT distracts attention from the contribution of investments provided through the governmental, quasigovernmental, and nonprofit sectors in such areas as infrastructure, education, health care, housing, security, and other public goods. These goods are provided by non-market-based institutions precisely because the profit-motive is too short-sighted to allocate assets efficiently to these endeavors.

Put most simply—MPT fails to grapple with the complicated task of valuing the societal and environmental implications of investments, or even to give them the minimal respect of a passing glance.

The third weakness of MPT is that it fails to account for the possibility that markets may be in practice more dishonest and dangerous than they appear in theory. Nassim Nicholas Taleb, in his recent rant against current financial practices, tells a fictional tale about asking a professor what the odds of a coin that has been flipped 99 times and comes up heads each time would be of coming up heads again on the hundredth flip. The professor's answer is 50-50, because odds do not change simply because of chance variations. When he asks the same question to his street-wise friend Fat Tony, however, he gets a very different answer. Fat Tony would give you only a one-in-a-hundred odds of heads coming up the next time. Why? Because "The coin is clearly rigged. It can't be a fair game." (Taleb 2007)

The point of this story is that, while many of the risk-control techniques that have been sold to the financial community as insurance are theoretically sound, they don't work when widely used. What's worse, they can actually increase the chances of systemic collapse. For example, a set of hedging techniques were developed by two academics from the University of California, and widely marketed to the financial community in the early 1980s as "portfolio insurance." By early 1987, some $70 billion in assets were theoretically insured against market declines of theoretically predictable magnitude. However, during the precipitous stock market crash of October of that year, these insurance policies not only failed to protect investors against large losses, but even contributed to the size and speed of the crash. The more investors used this insurance technique, the greater the chance it would fail in exceptional circumstances. (Bernstein 2005; Bookstaber 2007)

The same is true for other derivatives. For example, credit default swaps (CDSs) are often billed as a form of insurance. This esoteric product, developed within the past decade to help lenders control the riskiness of their loans, had become so popular that as of 2008 some $65 billion in notional assets were so insured. Here's one example of how a CDS might work. A bank lending $10 million to a major U.S. corporation can enter into a credit default swap with a hedge fund. The hedge fund agrees to pay the bank the $10 million if the corporation defaults on this loan any time within the next five years. In consideration for this service, the bank pays an "insurance" premium to the hedge fund each year, nominal if the chances of the corporation defaulting are minimal, or greater if the corporation is in financial difficulty.

If I'm a speculative and profit-minded banker, however, I might decide to enter into two or three CDSs for this loan, instead of just the one. After all, if the corporation defaults I am now not only protected against a loss, but stand to make a tidy profit. In fact, the next time that corporation comes to me for a loan, I might be willing to make one that is more risky at a higher interest rate because, using CDSs, I can make more money whether the loan is paid off or not.

The problem with this scenario—which one might view as a win/win for both the corporate community and the bank (corporations have access to risky loans, the banks are protected against default)—is that as more and more investors take out CDSs on risky loans the less likely the hedge funds or other third parties are to be able to pay if these corporations actually default. (Sarra 2008)

Michael Lewis has said of the credit default swap, "Call it insurance if you like, but it's not insurance most people know. It's more like buying fire insurance on your neighbor's house, possibly for many times the value of that house—from a company that probably doesn't have any real ability to pay you if someone sets fire to the whole neighborhood." (Lewis and Einhorn 2009)

This is true of many hedging techniques in the financial world. They are sold as insurance, but they are no such thing. They work only if limited numbers of investors use them. As more investors pile onto the risk control techniques that have been developed to implement MPT, the more likely they are not to work. This is why Gao Xiquin says they "cheat people."

IT TAKES AN ALTERNATIVE THEORY

MPT's assertions about risk control are in many senses too good to be true. It is this attractiveness—the promise of a free lunch—that has made them so popular within the institutional investment community.

Investors always have a difficult time saying no to a good deal. Those that invested in an outright fraud, such as the Ponzi scheme run by Bernard Madoff, should have known better, should have done their due diligence more thoroughly, and should have seen that the promise of an unbroken series of positive returns could not be kept. The remedy for this kind of abuse is straightforward —as a fiduciary, do your job, don't be seduced by fraud.

The problem posed by a world of institutional investors exercising their fiduciary duties under the precepts of MPT is more complicated. MPT is progress in the sense that it works for some investors all the time, and all investors some of the time, but it doesn't work for all investors all the time—and it cannot. It cannot because it is the right answer to the wrong problem.

The question responsible investors should be asking themselves is not "How can risk be controlled at the portfolio level?" A better question for MPT to have addressed might have been "How can risk be controlled at the market level?" But even that question isn't the right one—because risk cannot be controlled. Risk and speculation are part of the investment process and they can no more be eliminated from it than death can be eliminated from life.

It is as if fiduciaries were persuaded to enter a casino by some smart people with promises of a system to beat the house. Their initial allocation of assets to slot machines and the roulette wheel paid off handsomely, but now everyone seems to be using the system and it is breaking down. The problem isn't that these investors need a better system or even a better casino. What they need is a better theory of what to do with their investment funds to begin with.

In order to develop a theory that will compete successfully with the allures of MPT, the definition of the goal of investing must be changed. As long as success in investing is defined as controlling risk and beating price-based benchmarks, risk-taking and speculation will become irresistible to investors at some point and the markets will again find a way to fill that demand.

A theory of investment that can stand up to MPT will, I believe, relate success in investing to the social and environmental purposes for which particular investment asset classes were created.

After all, banks were not created so that depositors could earn interest. They were created to help support family-owned businesses and local economies. The purpose of issuing bonds is not to help citizens make money, but to fund the creation of public goods by governments acting in the public interest. Stock markets didn't come into being so that investors could beat benchmarks, but to fund large-scale business enterprises providing useful products and profits for a community of stakeholders. A conception of success in investing solely as achieving better returns than those of your neighbor, no matter what the asset class in which you are investing, is limited, impoverished, and anemic.

An alternative to MPT and current financial practices needs to be built on a foundation of investments that maximize the societal goods they are best at creating. This necessitates understanding the risks involved—risks certainly cannot be ignored. More importantly, however, it involves understanding the specific needs that investments fill, the specific goods they create, and the specific rewards they bring to the society and environment in which we live.

Successful, effective investment is as much about particular rewards as it is about generalized returns. Understanding how investments relate to the asset classes through which they are made will promote a world of lesser risks—financial, societal, and environmental—and greater long-term rewards. Defining the purpose of investment as achieving these ends is a short, quick road to creating the demand that will help stabilize financial markets and sustain long-term societal wealth.

The current economic crisis is a rare moment of opportunity to rethink the fundamental purpose of investing and to invent the tools that serve this purpose. The key to such rethinking is to define investment as a means to socially purposeful outcomes rather than a numbers game built on a societally inadequate theory. ■

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ENDNOTES

1 What is frequently referred to as the Nobel Prize in Economics is technically the Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel, which has been awarded annually since 1968 by the Swedish national bank. The Nobel Prizes for achievements in physics, chemistry, medicine, literature and for peace have been awarded by the Nobel Foundation since 1901.

2 MPT has also succeeded in converting investing from an art into a science, in the sense that investing

according to MPT has become a highly complicated, rigorously quantitative exercise for which physicists and mathematicians at the highest levels (the proverbial rocket scientists) are necessary. In making this conversion, MPT has achieved an underlying goal of taking personal preference and politics out of the investment process. The assertion that the personal and political should have no role in investment is not simply a practical consequence of MPT's rules, it is a dogmatic belief fundamental to its religion. This making over of investment into an impersonal science has the virtue of restraining conflicts of interest and opening up the investment world to merit and skills that are independent of class and entrenched power. Discussing the strengths and weaknesses of this other aspect of MPT, unrelated to its attitudes toward risk, is a separate topic not dealt with here.

How Should the Economy be Regulated?

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WHEN THINKING ABOUT HOW THE economy should be regulated we need to make a totally fresh start. This is because very little creative thinking about this critical subject has occurred for several decades. Specifically, the current economic crisis is a stark reminder of how outmoded regulatory structures are in relation to the current structure and function of the financial industry, though problems of the financial industry are not the sole or even main cause of the broader economic crisis. But even in the absence of a crisis, rethinking the fundamentals of economic regulation would be long overdue.

Patching a generally broken regulatory system is not enough in the U.S., or internationally. We need new principles on which to base a new approach to regulation, principles that help guide corporate investment decision-making and business management toward practices and outcomes that are much better aligned with the great social and environmental challenges that lie ahead. Fortunately, the six principles that the Corporation 20/20 project has already developed for corporate design are also highly relevant to thinking about new regulatory designs and processes.[1] As these principles make clear, the world's critical social, economic, and ideological challenges, often lumped under the rubric of how to achieve "sustainable development," demand the more targeted and directed use of new capital investment. Unfortunately, the world cannot rely on traditional capital markets alone to properly prioritize the future need for capital among key industries. If we could continue to rely on capital markets to properly allocate capital investment, we would not be facing the multiple crises that are now upon us. At the very least, we need a strong form of "managed capitalism" to guide corporate bodies toward socially-beneficial decision-making.

Regulating the "economy" means regulating all economic sectors of society broadly speaking, not just the financial sector which is most in the public eye today. This means inclusion of almost all areas of society where money or services change hands, including, in theory, the government itself Listing some of the obvious institutional forms comprising the economy, we have: for-profit public corporations, for-profit private corporations, non-profit institutions of many stripes such as hospitals and universities, small businesses with a single owner, worker-owned corporations, and cooperative societies. The economic sectors that require varying degrees of regulation include: retail, wholesale, financial services, manufacturing, mining, farming, education, health care, and housing, among other sectors.

Given all the permutations and combinations of these types of corporate entities, and these sectors of the economy, we have a very wide range of situations that need to be regulated in order to advance broad social goals. For each combination of corporate form and economic sector, one key question is how much and what kind of regulation is needed, and who should regulate?

ACTORS AND AGENTS

In beginning to think about how to regulate the economy, first consider all relevant relationships between the "big three": businesses/non-profits, government, and civil society. In particular, the proper role that civil society should play in regulation has generally been neglected, in part because even most proponents of strong regulatory processes have not recognized the important pro-democratic benefits that can flow from the more active involvement of civil society in regulatory processes. Since the economy, in the broad sense, comprises many different kinds of institutions, many of which are only partially participants in markets, the appropriate mode of regulation needs to be very different from industry to industry, and from type of market to type of market. In addition, "regulation" does not necessarily just mean regulation by government agencies, even though most regulation probably should be overseen, in a legal sense, by a government or quasi-government agency or commission. And, of course, government functions themselves can be divided into executive, legislative, and judiciary branches, which further complicates the picture.

In addition, there are external factors that affect the optimal regulation of various sectors of the economy. For example, corporations that have a major social and/or environmental impact clearly need more regulation than small businesses that have much less impact. The potential for systemic impacts and risks should also be a justification for more strict and comprehensive regulation. Thus, financial institutions have to be regulated in ways that the manufacturers of common household items do not. After all, the bankruptcy of even a major manufacturer of dishes, for example, would have little systemic impact on the economy. Furthermore, issues of potential market power (quasi-monopoly) also have to be taken into account when assessing the appropriate level of regulation. Then, again, there is a wide variety of labor, wage and salary, pension, health insurance, and health and safety issues to take into account In short, the picture that emerges is clear—no one size or type of regulatory approach fits all sectors of the economy.

WHY REGULATE?

In a capitalist market economy, what is the core rationale for regulation? To begin, sound regulation should attempt to prevent a wide range of problems from occurring, including, and this is new, the misallocation of financial resources. Obviously, more regulation of new financial products over the last 20 years might have prevented some or most of the serious damage to corporations and investors linked to the current financial crisis. More broadly, new forms of regulation are needed to help ensure that necessary principles of corporate design such as the Corporation 20/20 principles are, in fact, followed. These principles require that private interests serve the public interest, and that as part of serving the public interest all stakeholders should receive a fair share of all the wealth that corporations create. (See Corporation 20/20 principles #1 and #2 at www.corporation2020.org.) Thus, achieving the public interest in all its aspects must always be the core rationale of regulation.

The second important relationship between regulation and money arises when investment decision of all sorts are made. The need for regulatory mechanisms to foster more democratic control over a broad range of investment decisions, even those of private for-profit corporations, is greatly under-appreciated. Without greater democratic control over the full range of relevant investment decisions, the public interest cannot be achieved. The majority of the investments that society makes cannot be allowed to be controlled solely by private interests. To do so would most likely mean that neither corporations, nor thereby society, would function sustainably, nor would the wealth and other benefits generated by new investments be equitably distributed. (See, especially, Corporation 20/20 principles #3, #4, and #5 in this regard at www.corporation2020.org.)

Another type of problem which regulation addresses is the problem of the exercise of market power in various types of markets. If markets are not reasonably competitive, then either temporary or permanent regulation of those markets is justified to ensure enhancement of the public interest by achieving the fair pricing of products and services in those markets. Fair pricing also would help ensure that Corporation 20/20 principles #2 and #4 were implemented; namely, that the wealth and value generated by business would be distributed fairly among relevant stakeholders, especially consumers in this case.

Regulation can, then, have a profound effect on how society spends or invests its financial resources, and what it pays for its products and services. Markets do not necessarily yield optimal, aggregate investment patterns owing to information shortcomings, their failure to account for externalities and multiple social goals, and a lack of ethical considerations which would help direct the flow of capital to socially desirable ends.

Finally, as noted previously, regulation can and should be an instrument to ensure more democratic decision-making. This occurs, both by allowing greater public review of decisions and issues being regulated, by facilitating greater transparency and public disclosure of the information on which decisions being regulated are made, and by providing a platform for a wider range of stakeholder input into, and power over, relevant regulatory decisions, including investment decisions. (See Corporation 20/20 principle #6 which supports the right of natural persons to govern themselves, which should include their right to democratically decide how society's financial resources should be invested to achieve social goals.)

In contrast to these reasons for regulating institutions, markets, services, and products, there are common arguments against doing so. One main claim is that regulation is not economically efficient in many situations. Implicit in this claim, of course, is the view that economic efficiency is the most important factor to take into account when considering how to regulate the economy. In fact, economic efficiency is but one criterion by which to judge the performance of an economy and a society. The degree of democratic decision-making is another, perhaps more important criterion. And, no one approach to making investment decisions is going to lead to perfect outcomes, since no approach can achieve perfect foresight. Thus, having more democratic input to decision-making should help blunt criticism when some investments, in fact, turn out to be underperformers, as is inevitable under any set of regulatory or market structures.

A second argument against regulation is that it is often too expensive relative to its potential benefits. This argument is clearly related to the economic efficiency argument above, because doing a cost/benefit analysis of regulation is part of measuring economic efficiency. Of course, this argument is often disingenuous because the risks of proceeding with unregulated processes are usually not fully (or even partially) accounted for in such a cost/benefit analysis. Partly this happens because the analysts artificially segregate what they call public and private costs, as if private financial losses are not social costs as well, and vice versa.

Finally, some attack regulation on the grounds that it reduces the freedom of certain economic actors, such as business owners, to act in ways that they claim as an entitlement. The presumption behind this argument seems to be that people have certain "rights" to carry out their business without regard to their impacts, as if such activities exist in outer space. This argument tends to ignore the fact that without the existence of many social institutions—not the least of which are the courts, regulatory agencies, and the rule of law—doing business would be impossible. Of course, pro-business ideology tends to strongly emphasize the need for the rule of law to protect their property, but it is less enthusiastic about relying on the rule of law to protect the rest of society from the negative consequences of business enterprises themselves.

BETTER REGULATORY PROCESSES

What new regulatory institutions and processes should be created to advance the public interest while enabling responsible enterprises to prosper? One group that should be considered for a much more active role in future regulatory bodies is civil society, defined as all those organizations consisting of voluntary groups of citizens that form around a set of issues. Usually, these organizations are non-profits. They could be faith-based, unions, environmental groups, or PTAs, among others.

We also need to remind ourselves that regulation often works by regulating the activities of people, in addition to the institutions for which they work. This is often the case for workers whom we consider "professionals." Various types of professionals are often regulated by licensing standards aimed at strengthening the quality and safety of the services they provide. This approach to regulation applies to both doctors and public accountants, among many others. Probably other professionals should be more highly regulated as well, such as financial sector workers of various types. Of course, just because accountants must be licensed as individuals, does not mean that accounting firms that consist of many licensed accountants should also not have their operations regulated. But clearly there is an efficiency-related trade-off illustrated by this example between the efficacy of regulating individual employees, and the regulation of the institutions in which they work.

THE PUBLIC UTILITY COMMISSION MODEL

At least one somewhat obscure but potentially powerful model exists for a regulatory process that could regulate much of the economy in which medium-size and large corporations are the main actors. This is the American model of public utility commissions (PUCs). PUCs are best known for rate-setting with respect to energy, telecommunications and water. But even more important is their little-known role in approving all major utility *investments*, and all utility *products* for which they set rates. It is the fact that PUCs have the authority to approve investments that makes PUCs particularly powerful. They are given this authority to approve investments because a large part of the cost of all utility services provided to the public is the cost of paying off capital investments in plant and equipment.

In addition, the kind of investments approved by PUCs often determines many of the other costs of providing services to customers over a very long time period for any given type of utility service. For example, if a PUC approves a major investment in a new coal-fired electric power plant instead of in a new natural-gas-fired power plant, doing so commits the electric ratepayers to paying for coal, and not natural gas as the fuel, for the entire life of the power plant, which could be 50 years or more. This decision obviously has many environmental and economic impacts over the long term.

One of the most attractive features of well-functioning state PUCs (there is no exact federal counterpart) is that all decisions are based on evidence, as best the commissioners that serve on these commissions can determine the evidence. Evidence is gathered on all issues that the PUC is obligated to decide by holding formal hearings that must comply with administrative legal processes. Because administrative law is followed throughout the PUC hearing process, the decisions of PUCs can also be appealed to relevant courts. The evidence is supplied to PUC commissioners by witnesses who testify under oath in the hearings. The witnesses in a case are often experts in technical fields relevant to the issues being considered, but non-experts are often allowed to testify as well in order to get a broader range of public input into all decisions, many of which are basic policy decisions. Importantly, all witnesses can be cross-examined by the lawyers of the legal parties to the case to try to further determine the weight that should be given to their testimony, just as occurs in most courts.

In PUC proceedings, all parties to each case are allowed to ask formal discovery questions (make information requests) of the business being regulated, so that reliable and complete information can be relied on by each party to the case. Because of the discovery process, the information advantage that unregulated corporations usually have relative to the general public when it tries to comprehend corporate decisions is greatly reduced.

Importantly, a wide range of types of organizations, corporate, governmental or civil society, can be legal parties in PUC cases. Thus, widely diverse opinions and positions are represented, and usually supported by legal counsel. Sometimes the PUC orders the regulated company in a case to pay for the legal and expert witness costs of representation for stakeholders who do not have sufficient income to pay these costs themselves. This element of the PUC process ensures the fair and relatively equal representation of all stakeholders. Finally, the PUC commissioners and staff members themselves should be chosen from a diverse set of stakeholders, so that democratic decision-making could be even further enhanced.

One implication of applying this PUC model to non-utilities is that regulatory decision-making processes would become far more transparent and publically accessible than is typically the case. For example, currently, many federal regulatory bodies merely allow comments on proposed rules to be submitted, but open public evidentiary hearings are not held so as to open up the internal decision-making process. (This includes the Security and Exchange Commission, the Environmental Protection Agency, the Federal Energy Regulatory Commission, and the Federal Communications Commission, among others). Undemocratic "back-room" deal-making would be a lot more difficult under a PUC-like regime because PUCs also have to write formal orders explaining exactly what their decisions are, and the basis for them, as rooted in the evidence presented in each case. Of course, no regulatory process can ever guarantee that the regulatory decision-makers will balance all relevant arguments and societal interests in a reasonable way consistent with the evidence presented to arrive at the true "public interest." But such fallibility pertains even more so to private corporate decision-making by Boards of Directors and executives of corporations wherein balanced stakeholder input is rarely the case even for decisions with long-term social and environmental consequences for the public-at-large.

Industrial Regulatory Boards and democratic control of investment. In an earlier paper I have proposed that Industrial Regulatory Boards (IRBs) be established in each major industry along the lines of the PUC regulatory model as described above.[2] Each IRB would be composed of commissioners and technical staff with industry-specific expertise. Depending on the regulatory needs of that particular industry, each such IRB would have somewhat different responsibilities and types of authority to cover different sets of issues, as needed, to promote the public interest. The scope and depth of regulation would vary with the scope and depth of each industry with respect to environmental and social impacts. Diverse stakeholder interests would be represented at all levels of the IRB regulatory process.

The focus of each IRB should be to ensure that appropriate financial investments are made by each industry in a way that mutually reinforces the need to achieve key social and environmental goals over the coming decades, with mitigating climate change chief among these goals. In fact, given how little time the world has to mitigate climate change, water shortages, and the associated human dislocation, among other problems, it is inconceivable how unregulated and undirected corporate investment decisions could even come close to putting the world on a reasonably safe and certain trajectory towards climate stabilization, and sustainable development in general.

The IRB/PUC model would work in the following way. Whenever a business of significant size wanted to invest more than a specified minimum sum of money (e.g., $10 million) in a new production facility for an existing product type, or to create a new product or service, they would apply to their industry IRB for approval of this investment. The IRB would seek further information regarding the investment, as it deemed necessary. If the investment proposed was relatively small and non-controversial, the IRB would have the authority to issue an order approving and/or modifying the investment without a formal hearing, but informal input would still be solicited from relevant stakeholders. If the applicant accepted the order, the investment could go forward. However, if the investment proposal was large and/or controversial, then the IRB would determine that formal hearings should be held. This would involve a full-scale review of the evidentiary and policy issues relevant to whether or not the proposal should be approved, with or without modification.

It is important to note here that generally the initiative to invest would come from either the relevant private or public corporation, and not from the regulatory body or the government. Thus, typically, no agency of the government would require that any new investment be made by corporations. However, in other situations, a particular industry IRB might have certain legal responsibilities to achieve certain social goals, such as keeping the electricity system reliable. In such a case, the IRB might need to find either an existing public or private corporation that would be willing to make the relevant investments needed to achieve that social goal. If no existing corporation was willing to do so, a new public corporation might need to be established with governmental financial support to enable this social goal to be achieved. An example of where such a need might often arise is the need for more affordable housing for the poor and lower middle class.

Thus, the core motivation for the enhanced (or new) regulation of key corporate (and government) investment decisions is to ensure that society's scarce capital is not misdirected, especially during the coming critical decades during which a massive "green" New Deal, among other investment programs, will be required to meet the world's pressing social and environmental goals.

Different impacts, different regulatory regimes. As discussed above, each industry is unique in structure, technology and impacts on society and the environment. This reality is the foundation for developing a range of regulatory "intensity" to meet society's sustainability goals. To illustrate, consider the four industries below:

1. Agriculture (patented seeds): In the U.S., the full range of social and environmental impacts of new patented seeds has not been deliberated in an open PUC-like, methodical process, even though such issues have occasioned widespread concern and criticism in the NGO community. For example, no regulatory body, at least in the U.S., has the authority to take the impact of expensive patented seeds on the finances of farmers into account as a basis for restricting the production or creation of new seed types. Yet new patented seeds have stirred tremendous controversy both here and abroad, with regard to their social impacts as well as biological impacts.

If an Industrial Regulatory Board existed for the agriculture industry, the Board would also have to investigate the relationship between a company patenting certain seeds and the price they could charge for them. After all, patented seeds greatly reduce the possibility of competition among seed producers, and thus the possible exercise of market power has to be reviewed. Thus, patented seeds might have to be price controlled, so that only a fair rate of return on the relevant investments could be charged to customers. Also, of course, the social and environmental disruption that patented seeds might cause would have to be considered before such an IRB could approve any new seed products.

2. Chemicals: In contrast to the fact that there are thousands of chemicals manufactured in the U.S. that have never been tested for safety, a chemical industry IRB would prevent such a situation from ever arising. The IRB could ensure this since it would have the power to disapprove any new chemical product if it were not in the public interest. Furthermore, since most existing chemicals are made from fossil fuels and other minerals, such an IRB could force producers to back off these raw materials in order to move towards renewable sources of energy and chemical feedstock such as biomass. Many, if not most, organic chemicals can, in fact, be made from biomass feedstocks. In addition, chemicals made from unsustainable minerals could be phased out if other chemicals deriving from more sustainable feedstock would suffice in their place.

A chemical industry IRB should also set up a cycle of hearings in order to review whether or not the production of each existing chemical product should be allowed to be continued based on new evidence of its environmental impacts as they emerge. The ability to recycle or reclaim various chemical agents would also be a consideration in the Board's deliberations. Presumably, such a Board would adhere to a precautionary principle approach to such matters. Again, as with patented seeds, if a new chemical product were both patented and so unique as to lead to the likelihood of a quasi-monopoly in the market for such a product, then its price would have to be regulated, as well. Certainly, a chemical industry IRB would carefully regulate the location environmental impact of any new chemical factories or refineries. Finally, a chemical IRB could review national production levels of all chemicals in order to determine the need for all the chemicals currently produced.

3. Pharmaceuticals: Even though the U.S. currently regulates drugs through the Food and Drug Administration (FDA), there are many weaknesses in the FDA's operations relative to how a full-fledged pharmaceutical industry IRB would function. First of all, an IRB could prohibit patented copycat drugs where substitutable generic drugs would suffice, in order to reduce wasted investment within the industry. Also, the review and approval procedures for each new drug could be significantly democratized through the public hearing process that all Boards would be required to utilize in most cases. This would allow citizen and civil society input into all decisions in a way that currently is impossible when drug applications are reviewed. Thus, citizen groups could call their own expert witnesses to testify in such hearings along with industry and agency staff witnesses. This would help break the current dependency of agencies such as the FDA on scientists whose work is funded directly by the industry that the FDA is attempting to regulate, a topic of much recent controversy.

And again, if the likelihood of a company having market power for any given product could be demonstrated due to its unique features, then the new IRB would regulate the price of this product, which is something the FDA has no current power to do. Neither the Federal Trade Commission nor the Justice Department currently makes such determinations as to the need for price controls for pharmaceuticals under U.S. anti-trust statutes. (Or, at least, such determinations are extremely rare.) Similarly, in situations where government research funds helped facilitate the discovery of a new drug, then a pharmaceutical industry IRB could force the relevant manufacturer to share its profits from selling that drug with the government.

4. Financial services: In the wake of the economic crisis, a broad-based consensus has emerged calling for revamping financial services regulation. But beyond that general point, agreement on a detailed set of regulatory structures has yet to materialize. For example, almost no one is advocating bringing more transparent and democratic procedures to the deliberations of the Security and Exchange Commission, the Federal Reserve Board, or the Treasury Department. In fact, those agencies are notorious for depending on fairly secret back-room deliberations and negotiations for making policy, with only certain industry insiders being consulted. That type of process must be replaced with open hearings where both expert and non-expert input is garnered. Financial regulation is no more or less worthy of being based upon transparent and accountable processes than any other type of regulation, except, perhaps, during periods of extreme crisis which, hopefully, better regulation will help avoid. The potential social impacts must also be accounted for when a financial industry IRB decides which financial products are safe enough to allow, and the risk profile of each product should be made well known to all industry actors. Furthermore, as with any other IRB, a financial industry IRB should be staffed with a wide variety of industry experts, representing the full range of policy positions on relevant issues. The same should be true for the financial industry IRB commissioners themselves. The Board commissioners should not be limited to financial industry insiders based on the implicit assumption that other stakeholders could not possibly understand the relevant issues. Furthermore, federal-level financial regulation would have to be synchronized with state- and local-level regulations in this industry or, in the case of the insurance industry, federalized altogether.

CONCLUSION

The structure and function of all existing and future regulatory bodies needs to be rethought from a clean slate. Most regulatory bodies should be more strictly restructured around specific industries or commercial services, so that those bodies can focus on developing the right centers of expertise to better inform their decision-making. But all basic industries and sectors of the economy, including government agencies, should be covered by enhanced regulatory processes.

With rare exceptions, all regulatory board proceedings and deliberations should be completely public, based on evidence collected broadly from all relevant stakeholders under the powerful mechanism of administrative law. Generally, regulatory bodies should react to applications from public and private corporations for investment and/or new product approval. Civil society participants should be eligible for funding mechanisms in order to help ensure a diverse range of such participation. This implies that industrial (commercial) regulatory boards might also have to regulate the prices for many products and services, as well as the environmental and social impacts of such products and services, if market power is found to exist in certain industries. This is because technological change and industry structure may allow certain providers of these products and services to be able to exercise market power in relevant markets, so that the pricing of goods and services could not be competitive. Finally, whether or not major new investments or new products and services are broadly in the "public interest" should be the guiding "bottom-line" criterion on which all regulatory decisions are ultimately based.

Regulation has long been defined in terms of maximizing damage control—namely, to limit the negative behaviors of business to ensure protection of the public interest. While to some degree this damage control mindset should be maintained, now is an appropriate moment in time to complement damage control with proactive, positive regulatory principles that are designed to achieve specific public purposes. With a broad spectrum of urgent social, economic, and environmental problems upon us, enhanced regulatory structures and processes stand as a key opportunity to mobilize all our social resources toward solving such problems, while at the same time enhancing democratic process and consciousness. It is this balanced blend of damage control and proactive principles for achieving society's goals that should shape the purpose and structure of regulation in the coming decades. ■

ENDNOTES

1 Please see www.corporation2020.org.

2 Rosen and Schweickart. 2006. "Visions of Regional Economies in a Great Transition World." Great Transition Initiative Paper Series. Boston, MA: Tellus Institute.

Work and Well-Being

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IN AN ECONOMY FOCUSED ON GROWTH and individual gain, it is difficult to question the primacy of compensation among the indicators of welfare and create space for a broad discussion of the factors that contribute to well-being. Yet doing so is essential to corporate redesign. Earnings are but one contribution to a worker's well-being. A long and satisfying work experience, rich in opportunity and fulfillment, depends on a host of tangible and intangible factors. The current economic crisis provides a rare opening for rethinking the linkage between well-being and work. Doing so is long overdue. This paper aims to get the discussion rolling.

WHAT IS WELL-BEING?

The study of well-being focuses on an individual's prospects for a long, healthy, and satisfying life. It provides a framework within which quantitative assessments can be developed. Like the acreage of a field, well-being is quantified based on its "length" and breadth." The preferred measure of length is the World Health Organization's Healthy Life Expectancy (HLE) at birth. This is the number of years of healthy life a newborn can expect given current patterns of illness and death. Because it reflects current patterns not their evolution over the infant's life, HLE provides an indicator of physical well-being for the current population.

The measure for breadth, referred to as Subjective Well-Being (SWB), is the average level of life satisfaction determined on the basis of a standard survey question scored on a scale of one to ten. (Layard 2005) Using these measures overall Well-Being (WB) is quantified using the following formula:

WB = (HLE x SWB) / 10

The division by 10 is an adjustment made so that the values of WB lie in the same numerical range as human life spans. WB has a simple meaning. It is the satisfaction-adjusted healthy life span.

There is a tendency to think that well-being as just defined fails to reflect many aspects of life because they are absent from the WB equation. In fact, that isn't the case because of the way the survey question used to assess SWB is framed. The question asks how satisfied is the respondent is with life **as a whole**. Thus, in principle, all aspects of life are taken into account.

Physical and subjective well-being are separate but overlapping areas of scholarly interest. The section of the *Measure of America* (Burd-Sharps et al. 2008) captioned, "A Long and Healthy Life," provides a good introduction to physical well-being. The recent book, *Happiness – Lessons from a New Science* (Layard 2005), provides an introduction and overview of major results concerning SWB. The construction of an overall well-being index as the product of physical and subjective well-being is discussed in the paper by Nic Marks on the *Happy Planet Index*. (Marks 2006) Use of the product is the idea of Ruut Veenhoven, a well-known expert on well-being, who argues that it provides the best overall measure available. When other references are not provided, results on physical and subjective well-being can be assumed to come from Burd-Sharps et al. and Layard.

Well-being, as just described, is an individual attribute. Both of its components—HLE and SWB—are in part genetic. However, unlike hair and eye color, economic and social conditions have important effects on each of them. It is these effects which are relevant to the exploration of the linkage between work and well-being.

HOW MUCH DOES COMPENSATION MATTER?

Compensation—consisting of wages and benefits as well as bonuses, profit sharing and stock options—is assumed to provide the most important linkage between work and well-being. This view is reflected in the efforts of individuals and households to “get ahead,” and in negotiations between labor and management. If, however, gains for some are not to be offset by losses for others or eaten up by inflation, then income, defined as the average real Gross Domestic Product per capita, needs to grow. Thus, it is growth in income that is the focus in national and multi-national economic policy.

The focus on income growth reflects a broad consensus that the way to increase well-being is to have vigorous income growth which permits real growth in compensation. In the face of this consensus, the results obtained from the study of well-being are somewhat surprising:

- Historical analysis shows that while increases in income have accompanied gains in lifespan, they are not the cause of such gains and indeed have played a modest role in producing them.
- It remains an open question whether increases in SWB accompany gains in income over time. The importance of relative income and adaption suggest that any effect of income growth on SWB will, at most, be modest.

HLE AND INCOME GROWTH – CORRELATION BUT NOT CAUSATION

The historical record shows a clear association between income and lifespan. This has led historians to investigate the role of income growth in causing the increase in lifespan. Medical scientists, for whom distinguishing causal relationships from mere statistical associations can be an issue of life or death, have developed standard criteria to apply in such investigations. The only mandatory criterion is “temporality”—the cause must precede the effect. Careful historical studies show that, for a number of nations, increases in lifespan have occurred with only minor gains in income. Further, for the rich nations which currently enjoy the longest lifespans, much of the increase in lifespan took place while income was low.

Medical scientists also look for a general mechanism which links cause and effect. Historical studies show that the developments that led to gains in lifespan were quite diverse. The studies reveal neither a “general mechanism” nor even a common role for income. Instead, what they show is that gains in lifespan depend on the existence of nation-specific social structures and relationships which are utilized to produce changes—more frequent hand-washing, human waste disposal away from drinking water, acceptance of immunization, etc.—which in turn increased lifespan. (Riley 2008)

Insight into the relationship between income and HLE can be gained by considering the situation in the U.S. The U.S. has a significantly higher income and spends much more per capita on health care than Japan or the nations of Western Europe but has a lower HLE than either. HLE varies across the states in the U.S. as does income. Statistical analysis shows that only 12 percent of the variation in HLE is explained by the differences in income. What explains the other 88 percent? The answer is a variety of factors. Some are things one would expect, such as the extent of health insurance coverage.

SWB AND INCOME GROWTH – A WEAK RELATIONSHIP AT BEST

Unlike lifespan, there is very little long-term historical data on SWB. The best data available is for the U.S., Western Europe, and Japan. It covers only the period from 1950 to the present. During this period the gains in income for these three nations ranged from roughly three- to ten-fold. (Maddison 2007) For the U.S., experts have been unable to find any evidence of accompanying gains in the average level of SWB. For Western Europe and Japan researchers have recently found some evidence of very modest increases in SWB. However, this finding is controversial. There is no explanation why Japan and Western Europe would behave differently than the U.S. Nor is there the type of historical analysis required to explain the role that income gains play in causing increases in SWB.

Why massive gains in income were not associated with clear, substantial increases in SWB has been the subject of much research. The results highlight the importance of relative income and adaption in limiting change in SWB. To appreciate the importance of relative income in determining SWB, a well-known research result will be helpful:

- College students in the U.S. were asked to imagine two different outcomes when they entered the work force. Either they would earn $50,000 while their classmates would average $25,000 or they would earn $100,000 while the others would average twice that. The students were asked which outcome they would prefer. Most chose the first.

The preference expressed by the students is typical. In determining SWB relative income generally matters quite a bit. As a result a large increase or decrease in income over time that leaves the income distribution relatively unchanged has little effect on the average level of SWB.

Adaption leading to growing expectations also helps to explain how massive shifts in income may be accompanied by little or no change in SWB. Here again consideration of a bit of research conducted in the U.S. is useful.

- Between 1955 and 1985 the Gallup Poll asked respondents to indicate the smallest amount of income a family of four needed to get along in their community. The required real income rose, tracking the growth in actual real income.

What this result shows is that simply having the "necessities of life" was seen to require substantial income growth. Of course, had income growth been lower, expectations would likely have remained lower, and adverse impacts on well-being would have been avoided. Thus, through adaption, changes in SWB decouple from changes in income over time.

LOOKING BEYOND INCOME GROWTH

Research on well-being shows that income growth has, at best, a limited impact on well-being. This is not a reason to ignore income gains, and particularly the workers' share of them. Indeed, standard economic theories of wage determination stress the importance of perceived fairness in setting wage levels. (Akerlof and Shiller 2009) Rather, the point here is that to adequately address well-being, corporations must look beyond income growth and consider working conditions.

Occupational health and safety regulations are found in virtually all nations, rich and poor, though enforcement of course varies widely. However, the focus of those regulations is generally quite narrow. If the design of future corporations is to effectively foster worker well-being, a broader focus is essential. Two key aspects are hours worked and job security. Both have a significant effect on both SWB and physical well-being in the U.S., and lesser effects elsewhere.

In the U.S., between 1970 and 2000 the percentage of men working 50 hours per week or more increased significantly. For women the percentage more than doubled. Toward the end of the period a survey was conducted in which participants were asked to compare their ideal and actual hours of work. Roughly 60 percent said the ideal was lower, while less than 20 percent said it was higher. 28 percent said their ideal was at least 20 hours less than actual. It is fairly easy to understand how working more than one considers ideal might adversely affect SWB. (Jacobs and Gerson 2004) Outside the U.S. work time is less of an issue. However, the increasing intensity of work is a concern both within and outside the U.S. (Green 2007). In general, this increase has the same adverse impact on SWB as long hours.

Job insecurity, or simply a significant increase in the unemployment rate, has been shown to have a significant adverse impact on SWB. Here much more than concern about a drop in income is involved. Employment provides an important part of an individual's identity and sense of self-worth. In rich nations other than the U.S. there is generally greater job security. However, it is often more difficult for those entering the job market, initially or after a job loss, to find employment. This is simply a different sort of "job insecurity," with the same adverse impacts on SWB.

There are a variety of connections between long hours and insecurity and workers physical well-being. Some, such as the adverse impact of long hours on time available for exercise, are relatively direct. Others are more subtle. Long hours and insecurity are sources of stress which, in turn, have adverse physical effects. In addition, working more hours than desired or worrying about job security can make individuals less able to maintain a satisfactory marriage and friendships, both of which contribute to physical well-being, in part by helping the individual cope with the impacts of stress. (Helman 2007)

REDESIGN RAISES THE WELL-BEING ISSUE

The principles developed by Corporation 20/20 begin with the observation that the purpose of the corporation should be to harness private interests to serve the public interest. After addressing fair returns, sustainability, equity, and governance, the principles conclude with the requirement that the corporation not infringe on universal human rights. Well-being is certainly part of the public interest. The right to pursue it is arguably a universal human right.

Redesign is the principal strategic approach put forward by the Corporation 20/20 project. The mission statement for the project makes it clear that Corporate Redesign is to shift the focus from the production of goods and services to the nature of the corporation, particularly its purpose, its character, and its architecture. (Corporation 20/20) This framing of redesign raises two questions related to well-being:

- **Purpose.** Should part of the corporate purpose be to help workers maximize their well-being?
- **Character and Architecture.** How does the current character and architecture of the corporation need to change in order to fulfill its legitimate purposes relative to workers' well-being?

The Corporation 20/20 principles show that the answer to the first question is "yes." Turning to the second, the issue is how and to what extent the current character and architecture of the corporation be changed.

WHAT IS THE SCOPE FOR ACTION?

Long hours in the U.S. and the more general increases in the intensity of work reflect the increasingly competitive nature of the global economy. Dealing fully with these issues leads to a discussion of the desirability of such an economy. However, even accepting the highly competitive global economy as a given, there are measures that corporations, acting individually and collectively, could undertake to enhance worker well-being. Doing so is not a matter of altruism; such measures arguably have positive consequences for productivity and long-term prosperity of the organization.

In the U.S, working "long hours" (i.e., 50 or more hours per week) is most common among highly educated management or technical personnel in whom a firm has a substantial investment. The corporation pays the costs in absences from work and turnover associated with the hours they work. Similar costs are associated in general with intensity of work.

Job insecurity is also due in part to structural features of the modern economy. Consider for a moment the pace of change. In the U.S., between 1990 and 2003, the net change in the number of jobs was modest, averaging growth of .3 percent per quarter in the private sector. However, that .3 percent was the difference between job destruction of 7.7 percent per quarter and job creation of 8.0 percent. (Cahuc and Zylberberg 2006) With such turbulence, job insecurity will, of necessity, be a continuing worry.

Workers' concern about possible job loss is increased by typical labor practices. Faced with a downturn, employers typically choose layoffs rather than reductions in hours and wages spread across most or all segments of the workforce. The rationale is that, while both have adverse effects on workplace morale, with layoffs most of the problem goes "out the door." If the well-being of workers is a concern, reductions in hours would be the preferable option. If the reductions were made and conveyed in a way that increased worker security, well-being would likely be enhanced.

Individual firms can assess what actions to reduce hours and increase job security might be cost-effective and feasible for them. The ability to take such actions is, of course, limited by the behavior of competitors. Here, following the model established by the Global Reporting Initiative (GRI), it may be possible for the firms in various industries to come together and jointly adopt standards or practices which, if adopted individually, would lead to a competitive disadvantage.

IS THIS THE TIME FOR CHANGE?

To the extent that well-being is addressed in the corporate world today, the focus is on increases in compensation for the workers, returns and appreciation for the "owners," and benefits in the form of enhanced product quality and diversity as well as declining unit costs for customers. This approach reflects a tacit judgment that, if the corporation is contributing to the growth in income, it is doing what it can (and should) to foster well-being. Workers and those who represent them may question the sharing of gains with the owners, but they generally do not question the importance of increasing the incomes available for division.

The results on income and well-being discussed in this paper put all of this in question. Given the weak role of income in fostering well-being, the emphasis on growth is misplaced. A shift, based on an understanding of the ways the corporation affects the complex web of mechanisms and relationships which determine well-being is needed. In the U.S. hours of work and job insecurity must be addressed if a more effective approach to well-being is to be embedded in future corporate forms. .

While the challenge of addressing working conditions through corporate redesign is significant, the current financial turmoil may make action easier. There is a long history of social progress during times of financial crisis. The best-known example is the U.S. New Deal that changed key elements of the relationship between labor and management. (Friedman 2005) A more recent example is the work of Green New Deal Group in the U.K., which links progress on energy and climate issues to the resolution of the current financial crisis. (Elliott et al. 2008) Changes that under normal circumstances may appear to be impossible may be moved into the realm of plausibility when economic distress is widespread and business and political leadership are forced to re-examine the conventional wisdom. ■

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Rebecca K. Darr is the Senior Fellow of Corporate Programs at The Aspen Institute's Business & Society Program (BSP). She joined Aspen BSP in December 2007 in a newly created role to advance outreach to the business and investor communities on the Aspen Principles for Long-Term Value Creation and other work of the Corporate Values Strategy Group. As an independent consultant, Rebecca helps clients in North America and Asia with sustainability strategy development and operations improvement; clients include start-up and long-running businesses from multiple industries, social enterprises and NGOs. Rebecca was part of the first corporate responsibility team at Deloitte Touche Tohmatsu from 2004-2006 and was a management consultant with Deloitte Consulting from 1996-2004. Rebecca holds a B.A. from Rice University, received her M.B.A. from the University of Michigan, and completed a post-graduate certificate in cross-sector partnerships at the University of Cambridge, England.

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