Speech

My Beef with Stakeholders: Remarks at the 17th Annual SEC Conference, Center for Corporate Reporting and Governance

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Good morning and thank you, Fram, for the kind introduction. Before I begin my remarks, I have to give my standard disclaimer, which is that my remarks reflect only my own views and not those of the Commission or my fellow Commissioners.

I greatly appreciate the opportunity to be part of this conference. Last time I flew to California, the skies were so clear that I was able to keep an eye on the changing landscape below all the way across the country. The vastness and great variety was striking. Having grown up in Ohio, I can attest to the fact that the magnificence of the landscape is just one of the features that makes so-called flyover country remarkably beautiful. The wealth of talent and ingenuity in the people of the heartland is where the real beauty lies.

Indeed, one of the issues on which I am committed to working with Chairman Clayton and my fellow commissioners is ways to unlock the deep potential of the middle of the country by ensuring that our securities laws do not inadvertently prevent people from

investing in their own communities. Accredited investor rules, for example, have a different effect in Ohio, where incomes pale in comparison to lofty coastal paychecks. We also can work with states to ensure that the SEC does not stand in the way of state efforts to create innovation-friendly regulatory regimes. As the Chairman said when he spoke in Nashville several weeks ago, "There are obviously a lot of miles, many good, talented people, and many promising companies between the coasts," and I agree with the Chairman that we should "make sure our regulation of capital formation enables capital to flow to the areas in between."[1]

All that said, there is nevertheless something special about California. It is a place that provides fertile ground for innovation, imagination, celebration, and—to be frank—legislation.

As I was thinking about which topics to address today, one piece of legislation caught my eye. The California legislature has passed a bill that would set certain parameters for the gender composition of corporate boards. One of the fundamental aspects of corporate law in the US is the central role of states.[2] Corporations are state-chartered, which allows for experimentation of the nature California is contemplating with Senate Bill 826.[3] As I understand it, however, the bill would cover public companies incorporated in other states if their headquarters are in California.

Moreover, as they say, nothing that happens in California, stays in California. For that reason, I want to spend a few minutes today discussing concerns that I have about government attempts to remake corporations for the benefit of so-called stakeholders.

"Stakeholder" is certainly in the top ten list of words that get bandied about Washington. A bit behind "ecosystem" and a bit ahead of "sustainability." I am guilty of using all of these terms, but stakeholder is the one that weighs most heavily on my conscience.

"Stakeholder" is so popular precisely because it is so elastic. In the corporate context, however, that elasticity has some troubling implications. It is used to refocus corporate decision-makers on constituencies other than their shareholders. In the stakeholder-centric view of the world, a corporation and its directors owe a duty not just to shareholders, but to a broader group of "stakeholders."

The scope of that term varies with the user, which is perhaps one of the term's most alluring features. The term "stakeholder" typically includes the company's employees but almost always also extends to include a variety of individuals whose lives may be affected by the corporation in some way.[4] They may have a business relationship with the corporation as its suppliers, buyers, or creditors. They may interact with the company in their private lives, by, for example, living near premises owned or occupied by the corporation. In its most expansive definition, "stakeholder" can include those

with far more attenuated connections to the corporation. For example, the entire city or society in which a company operates can be deemed a "stakeholder" in the company's operations. Lest we feel left out of the stakeholder "ecosystem," regulators are often included in the term too.

Clearly, a company's operations do affect many of these groups. There is no denying that employees, suppliers, and localities often feel the effects of the choices a company's board makes. The question of who might be affected by a decision is, however, a different question from whether the company must consider their interests —separate and apart from the company's own interests—as part of any decision-making. That question is, in turn, separate from the question of whether these individuals, by virtue of their status as "stakeholders," are entitled to a say in how the company conducts its business.[5] I posit that the proper answer to these last two questions is "no."

That answer should not be shocking. In other areas of life, similar questions are similarly answered. As a resident of a condominium, I am a stakeholder of my neighbors. Decisions they make about what to cook, for example, have a direct effect on me, but I do not expect to be consulted in their menu planning. Yes, a neighbor wanting to maintain good neighborly relations will try to avoid burning toast every morning and may offer me a bowl of the fish stew he is making in order to keep me from complaining about the strong aroma. Cooking decisions are still his to make.

The competing interests of stakeholders in the corporate context are admittedly a bit weightier than neighborly culinary relations, but to mandate stakeholder engagement after the model of shareholder engagement is to ignore the ways in which non-shareholder groups of individuals already influence company policy.

Employees, creditors, suppliers, customers, communities, and regulators feature prominently in the thoughts of corporate boards and managers. All of these groups have avenues for making their voices heard by the companies with which they interact. Given the importance of many stakeholders to a company's success, these avenues are unlikely to be dead ends. Any competent manager, for example, understands the role that employee satisfaction plays in productivity, retention, and development. Creditors and suppliers negotiate contracts with a keen interest in furthering their own interests.

Community relations are likewise of paramount importance to companies. They often voluntarily take steps to ensure that they are contributing to the community's well-being. Regulation also can play a role in ensuring that, for example, a company takes into account the interests of its neighbors and others affected by the company's actions but without a contractual relationship with the company. Regulation can help to

internalize externalities.[6] Regulatory limits on noise, air, and water pollution fall into this category.

Directors of corporations, other than benefit corporations which are a unique and limited category, have a fiduciary duty to their shareholders to maximize the value of the corporation. There will inevitably be disputes about how to achieve this goal, but the objective is clear. In this context, it is important to remember that shareholders are not uniform and their interests are not always uniform.[7] They may have competing interests, but the directors work for the company, rather than any particular shareholder or group of shareholders. What is best for the long-term value of the company may not be best for each and every shareholder. Shareholders' best interests turn on what the rest of their investment portfolio looks like and what their non-investment interests in the company are. For example, a shareholder might be a stakeholder not only on the basis of her share ownership, but because she is an employee or neighbor of the company. Hence, the focus on maximizing the corporation's value, which in turn maximizes shareholder wealth—even if some shareholder may prefer the company to provide her with something other than financial value.

Directors and managers, for their part, sometimes may prefer to cater to stakeholders. Stakeholders may represent interests aligned with the personal interests of directors and managers. More generally, a mandate to serve imprecisely defined stakeholder groups affords managers and directors more latitude and makes their performance harder to measure. If the law allows directors and managers to elevate certain stakeholders over shareholders, the law is complicit in a breach of fiduciary duty.

Focusing on the company's long-term value also serves the public. The company's price, which reflects the market's view about the company's long-term value, serves a critical role in ensuring that the company is actually meeting the public's needs. One of the essential functions of securities markets is price discovery. As securities trade, information about the company's expected performance is incorporated into the price. A company increases its stock price by selling better products and services or producing them more efficiently and lowering its prices to attract customers. The better the company meets the needs and wants of its buyers, the more income it earns and the more value it returns to its shareholders. The stock price also helps to nudge companies to return resources to shareholders that the company cannot use productively. If a company cannot put resources to work, it returns them to shareholders, who can then put them to work in another enterprise that does have a good use for them. A company that serves the interests of its collective shareholders serves the interests of the public.

Requiring a company to instead cater to other interests therefore risks compromising not only its shareholders' interests, but the public interest as well. It complicates

boardroom decision-making and muddles the effectiveness of price as a signal of the company's value. Valuing a company that is dancing to the tune of multiple fiddlers is no easy task, so an uncertainty discount would inevitably be built into the price of the company's shares.

When an investor buys a piece of a company, the price she pays reflects certain understandings about the board's duty to the company, and by extension, to its shareholders. Directing companies to give priority to stakeholders rather than shareholders would lower the value of existing shares and hence the price investors are willing to pay for an ownership interest in the company.

While there have been discussions about the rights of stakeholders for many years now, they seem to be finding a particularly attentive audience these days. The aforementioned California bill, which awaits the Governor's signature,[8] embraces a stakeholder approach. The bill is prefaced with a finding that getting more women on boards "will boost the California economy, improve opportunities for women in the workplace, and protect California taxpayers, shareholders and retirees . . . ."[9] Shareholders are mentioned, but the list of beneficiaries features stakeholders prominently.

The bill cites evidence for the proposition that companies with women on their boards are better by a number of measures than other companies. My point is not to dispute the evidence, but to suggest that companies looking out for their long-term value already have strong incentives to take that evidence under consideration along with all the other factors that may affect the company's long-term value.

If a company must consider interest groups beyond its shareholders—a discrete and relatively easily identifiable group—it becomes challenging to draw the lines exactly right to include one group of stakeholders and exclude another. Even those who support the notion of stakeholder interests do not go so far as to claim that every person who is affected by a company in some form or fashion, no matter how attenuated the effect, should be deemed a stakeholder.

The California legislation effectively forces corporations, including non-California corporations, to consider all women as stakeholders. That is a big group. Once we introduce the idea that a company must act in the interest of some subset of its stakeholders, and condition the grant of a charter on its proper treatment of those deemed "stakeholders," policymakers might be tempted to get this or that favored group included in the stakeholder definition. Opening such a wide door introduces uncertainty and political influence into corporate operations.

We have a deep and well-developed body of corporate law. It rests on the assumption that the board owes its principal duty to the shareholders collectively, not to an

amorphous group of stakeholders. There is no compelling reason to overturn centuries of settled law, and there are many reasons not to.

The focus of the California bill—women on boards—is one piece of a broader set of ideas encapsulated by the snappy acronym ESG. ESG stands for "environmental, social, governance,"[10] but the "S" in ESG could just as well stand for "stakeholder." The corporation, the idea goes, should consider its impact on society as a whole. The ESG criteria establish standards of conduct for a corporation. Much like the word "organic," however, ESG may not be the same to you as it is to me. Companies are at the mercy of the standard setters, whose approaches to collecting and analyzing information differ.[11]

Many advocates of using ESG criteria cite data that support the claim that companies that implement ESG-friendly policies outperform those that do not. Testing this hypothesis is tough since, although discussed as one set of criteria, in fact, ESG factors typically evaluate an eye-popping array of corporate behavior. These criteria may cover everything from the number of women who sit on the board to whether a plant carries a green certification to the company's involvement in certain disfavored industries.[12] In considering what may contribute to a company's success, pointing to gender diversity, concern for the environment, and avoidance of "sin" products is so scattershot as to be useless. These factors simply have nothing to do with one another.

The only uniting feature is the motto most-often associated with ESG investing—"do well by doing good."[13] One of the core tenants of ESG investing is that it is ethical and good, but ethics and goodness are subject to interpretation. In fact, while some ESG factors—such as some of those associated with the "G" part—track with conventional notions of good business, many seem to be included in the ESG rubric because they hew to a what a select group of stakeholders believe to be good or moral behavior.

It may be useful to pause here and clarify an important point. If an individual wants to invest in companies that align with her moral beliefs, that is fine. An individual investor is certainly free to make trade-offs to risk lower returns for whatever other interest she may have. Nor is there a problem with certain funds pursuing stated social interest goals. Many such funds exist. Assuming they have disclosed their objectives as a part of their investment strategies they not only may, but *must* pursue the ESG guidelines they have set for themselves. Such funds have proliferated in recent years, and investors seeking to apply ESG standards to financial interests will find many options available to them. I am not taking issue with these arrangements as long as ESG investors do not force the companies in which they invest to take steps that harm the company's long-term value.

The problems arise when those making the investment decisions are doing so on behalf of others who do *not* share their ESG objectives. This problem is most acute when the individual cannot easily exit the relationship. For example, pension beneficiaries often must remain invested with the pension to receive their benefits. When a pension fund manager is making the decision to pursue her moral goals at the risk of financial return, the manager is putting other people's retirements at risk.

The difficulty in understanding the legal implications of using ESG to evaluate investments arises in part from the fact that the same investment may raise legal concerns or may be entirely appropriate depending on the fiduciary's intent. For example, investing in a company that develops green technology is likely appropriate if the fund manager makes the investment because of a belief that green technology's popularity will make it a profitable investment. If, however, the manager makes the investment because of a belief that it is virtuous to support green technology regardless of its commercial prospects, it becomes less clear that the manager has fulfilled her fiduciary duty.

If you do any research in this area, you will find that a considerable number, approximately 70 percent of managers by some estimates, say that they use ESG factors in evaluating their investments.[14] You will also find a number of articles and papers reporting that companies that have implemented ESG-friendly policies outperform those companies that have not.[15] From these findings, some have argued, that fiduciaries not only *may* use ESG factors, but that they *must* to fulfill their fiduciary duty.[16]

There are two problems with this conclusion. First, given the breadth of topics that the term "ESG" purports to address, it is difficult to say that, for any company, it is the ESG factors in particular that have resulted in higher returns. Second, because ESG can mean so many things, a company may implement a number of policies that wind up counted as "ESG" measures that are simply the same good practices that companies have embraced for centuries. The problem is that, because discrete, time-tested measures have good results, once they are dubbed "ESG," their success becomes an argument for implementing all kinds of unrelated, untested measures that conveniently share the ESG label.

Thus we arrive at the next problem with using ESG factors: there are no clear standards. Even if we were to accept—and I do not—that it is desirable to use funds held by large investors as a means of fueling social change, it is not clear that the factors managers now consider actually have the intended effects. In many instances, ESG reporting has been presented as though it were comparable to financial reporting, but it is not.[17] While financial reporting benefits from uniform standards developed over centuries, many ESG factors rely on research that is far from settled. Counting

the number of female directors may tell you something about how well a company is run. Or it may simply tell you that the company has more female directors. There are studies going both ways.[18] In most cases, the companies themselves are ill-equipped to make these determinations. Does a company that brews beer really have the expertise to assess what energy source would be the best for the environment?

A bit closer to home for me, neither do regulators have the requisite expertise to assess how well companies adhere to ESG standards and properly disclose whether their practices conform to those standards. We have a tough enough time with non-GAAP metrics.

I should note that there are efforts underway to establish such standards.[19] The problem is that, unlike financial reporting, many of these factors are not susceptible to standards that would be comparable across companies. If the research has had mixed findings, how can standards be set? In this case, poorly established standards may be worse than no standards at all. One of the core principles underlying modern accounting standards is the notion that financial statements should be comparable across companies. An investor should be able to place two companies' financials side-by-side and have an accurate sense of which company is performing better and in what ways. Imprecise or shifting standards create the risk that investors, and the market, will believe they can compare two companies on certain ESG factors when in reality the companies are quite different.

Second, there is a degree of subjectivity in the setting and application of standards. Some ESG standards seem to reflect personal moral beliefs that may not be universally held. Some funds cite to ESG standards as a reason for no longer investing in companies involved in the firearms industry.[20] Again, it is perfectly appropriate for any individual to choose not to invest in any industry she finds objectionable, and funds currently exist for individuals who want to screen out everything from guns to alcohol to gambling. But there is hardly uniform agreement among Americans on the subject of firearms, and many Americans see no harm in owning guns and gun stocks.[21] Our capital markets should accommodate both groups.

Once a standard is set, deciding whether a company meets it can also be difficult. Is a company that operates on solar power up to snuff enough to satisfy environmental standards, even if it uses fossil fuel to power its own plant?

Companies and their stakeholders have just begun to wrestle with these issues. Speaking for just one stakeholder—my regulatory self—I look forward to listening to the full range of views on these interesting and important issues. Thank you for your time

this morning. I would be happy to take some questions, even those that include the S-word.

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[1] Jay Clayton, Remarks on Capital Formation at the Nashville 36/86 Entrepreneurship Festival, Aug. 29, 2018, *available at* www.sec.gov/news/speech/speech-clayton-082918.

[2] *See, e.g.,* Roberta Romano, *The States as a Laboratory: Legal Innovation and State Competition for Corporate Charters*, 23 Yale J. on Reg. 209 (2006).

[3] S.B. 826, 2018 Leg., 2017-2018 Leg. Sess. (Cal. 2018).

[4] *See, e.g.*, Jensen, Michael C. "Value Maximization, Stakeholder Theory, and the Corporate Objective Function″ Harvard Bus. Sch., Working Paper No. 01-01, pgs. 8–9, *available at* papers.ssrn.com/sol3/papers.cfm?abstract_id=220671 ("Stakeholders include all individuals or groups who can substantially affect, or be affected by, the welfare of the firm—a category that includes not only the financial claimholders, but also employees, customers, communities, and government officials."); Green, Ronald M. "Shareholders as Stakeholders: Changing Metaphors of Corporate Governance," 50 Wash. & Lee L. Rev. 1409, 1411 (1993) (defining "stakeholder" to include employees and local communities); R. Edward Freeman & John McVea, "A Stakeholder Approach to Strategic Management," Darden Graduate Sch. of Bus. Admin., Working Paper No. 01-02, *available at* papers.ssrn.com/sol3/papers.cfm?abstract_id=263511 (stating that stakeholders include "employees, customers, suppliers, lenders and society").

[5] *See, e.g.*, Accountable Capitalism Act, *available at* www.warren.senate.gov/imo/media/doc/Accountable%20Capitalism%20Act.pdf (proposing that a corporation's employees select at least 40% of its directors).

[6] *See* Brito, Jerry and Dudley, Susan E., *Regulation: A Primer*, Mercatus Center at George Washington University, 2012.

[7] Hu, Henry T.C. and Black, Bernard "The New Vote Buying; Empty Voting and Hidden (Morphable) Ownership," 79 S. Cal. L. Rev. 4, May 2006.

[8] Cal. Legislative Info., leginfo.legislature.ca.gov/faces/billHistoryClient.xhtml?bill_id=201720180SB826 (last visited Sept. 20, 2018).

[9] S.B. 826, 2018 Leg., 2017-2018 Leg. Sess. (Cal. 2018).

[10] Investopedia.com, "Environmental, Social and Governance (ESG) Criteria," *available at* www.investopedia.com/terms/e/environmental-social-and-governance-esg-

criteria.asp.

[11] Mackintosh, James, "Social, Environmental Investment Scores Diverge," *The Wall Street Journal*, p. B1, Sept. 18, 2018.

[12] CFA Institute, Environmental, Social, and Governance Factors at Listed Companies: A Manual for Investors 12 (2008), *available at* https://www.cfainstitute.org/en/advocacy/policy-positions/environmental-social-and-governance-factors-at-listed-companies.

[13] *See, e.g.*, Georgescu, Peter "Just 100 Do Well By Doing Good," Forbes online, Jan. 10, 2018, *available at* https://www.forbes.com/sites/petergeorgescu/2018/01/10/just-100-well-by-doing-good/#5baace3c6335; PriceWaterhouseCoopers "Sustainable Investing: Doing Well by Doing Good," Dec. 2017, *available at* https://www.pwc.co.uk/audit-assurance/assets/pdf/hot-topic-sustainable-investing-doing-well-by-doing-good.pdf; Patsky, John W. "ESG Investing: Doing Good While Doing Well," John Hancock Investments, *available at* https://www.jhinvestments.com/ESG-investing-doing-good-doing-well.

[14] Morgan Stanley, "Sustainable Signals: Asset Owners Embrace Sustainability" pgs. 1–2, 2018, *available at* http://www.morganstanley.com/assets/pdfs/sustainable-signals-asset-owners-2018-survey.pdf.

[15] *See, e.g.*, Holder, Michael "Evidence Links ESG Performance to Better Investments," GreenBiz, Jan. 10, 2018, *available at* www.greenbiz.com/article/evidence-links-esg-performance-better-investments*;* Skroupa, Christopher P. "High ESG Performance Translates Into High Financial Performance," Forbes online, Jun. 16, 2017, *available at* www.forbes.com/sites/christopherskroupa/2017/06/16/high-esg-performance-translates-into-high-financial-performance/#6f49d7a1d708; Friede, Busch, and Bassen, "ESG and Financial Performance: Aggregated Evidence from More Than 2000 Empirical Studies," Journal of Sustainable Finance & Investment, 5:4, 210-233, Dec. 2015, *available at* www.tandfonline.com/doi/full/10.1080/20430795.2015.1118917.

[16] *E.g.*, UNEP Finance Initiative, A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment, p. 13, 2005, *available at* www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf , ("[I]ntegrating ESG considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguably required in all jurisdictions").

[17] This often manifests as a call for "integrated reporting," which would present financial, environmental, social, and governance performance together. *See, e.g.*, Eccles, Robert G. and Serafeim, George, "Accelerating the Adoption of Integrated Reporting," CSR Index, Francesco de Leo, Mattias Vollbracht, eds., InnoVatio Publishing Ltd., 2011.

[18] *See*, *e.g.*, Adams, Renee B and Ferreira, Daniel, "Women in the Boardroom and Their Impact on Governance and Performance," Center for Economic Institutions Working Paper Series, Hitsubashi University, April 2008 (finding that gender diversity on boards resulted in more monitoring behavior, which could negatively impact market valuation and operative performance for well-functioning firms); *The Economist*, "Ten Years on From Norway's Quota for Women on Corporate Boards," Feb. 17, 2018 (noting that "[g]ender quotas at board level in Europe have done little to boost corporate performance or help women lower down"; Ali, Liu, and Su "Women on board: Does the Gender Diversity Reduce Default Risk?", 9th Conference on Financial Markets and Corporate Governance 2018, Jan. 25, 2018 (finding that the presence of female board members decreased firms' default risk). A recent article discussing meta-analyses of peer reviewed academic studies concluded that there is "no business case for—or against—appointing women to corporate boards" and that efforts to increase women's representation should be based on fairness and equality. Klein, Katherine "Does Gender Diversity on Boards Really Boost Company Performance?", Knowledge@Wharton, May 18, 2017.

[19] For example, the Sustainability Accounting Standards Board defines itself as "the independent standards-setting organization for sustainability accounting standards that meet the needs of investors of fostering high-quality disclosure of material sustainability information." Sustainability Accounting Standards Board, "About the SASB," *available at* www.sasb.org/about-the-sasb. There are also firms that provide ratings and research for assessing ESG criteria. *See, e.g.*, Morningstar "Investing in a Sustainable Future," *available at* www.morningstar.com/company/sustainability; Sustainalytics, "ESG Ratings & Research," *available at* www.sustainalytics.com/esg-ratings.

[20] Strasburg, Gottfried, and Fuhrmans, "Firms Reassess Involvement in Gun Industry in Wake of Florida Shooting," The Wall Street Journal, Feb. 25, 2018, *available at* www.wsj.com/articles/firms-reassess-involvement-in-gun-industry-in-wake-of-florida-shooting-1519606834.

[21] *See* Evans, Rachel "Gun-Free ETFs Are Everywhere but No One's Buying," Bloomberg, Mar. 1, 2018, *available at* www.bloomberg.com/news/articles/2018-03-01/gun-toting-index-funds-retain-mom-and-pop-investors-amid-outcry.