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Why do we stand and watch while our economy is attacked by investors who are not accountable?

A debate is needed on the principles pertaining to the role of shareholders in public companies

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I. The imperative of our time: sustainability

After the wild years of the 1990s and 2000s, which were in many ways reminiscent of last century's Roaring Twenties, there was a sudden awakening: on September 15, 2008, the investment bank Lehman Brothers went bankrupt overnight, which led to a complete loss of confidence in the closely-connected worldwide banking system. The banks stopped lending each other money because they knew how exposed the whole system was, and that most of them were in a similar situation. Within days and weeks one renowned bank after another stood before the abyss. Only massive, unprecedented state interventions around the world saved the banks, their managers and even the hitherto successful Western economic system from a colossal crash. The state interventions led to a massive increase in debt held by many countries, the banking crisis was compounded by a financial crisis at state level, the Euro crisis precipitated economic turmoil and a crisis of confidence in many European countries, the long-term consequences of which cannot yet be foreseen.

«Never again!», was the worldwide consensus. The banks had to subject themselves to far-reaching, in some cases excessive, new regulations. Across the economy the call for increased sustainability rang out. Agreement on this was broad, and was also supported by the liberal press such as «The Economist» and many others. Unlike in banking, this call for more sustainability in the corporate world was not anchored in legal regulations, but in voluntary codes of good corporate governance, the so-called «Corporate Governance Best Practice Codes». For example, since 2009, the German Code of Conduct reads: «The Code clarifies the obligation of the management board and the supervisory board to ensure the continued existence of the enterprise and its *sustainable creation of value* in conformity with the principles of the social market economy», which is a complete departure from the previous basic principles. From 2002 to 2014 the Swiss Code of Best Practice defined corporate governance as encompassing «the full range of principles directed towards *shareholders' interest* seeking a good balance between direction and control and transparency at the top company level while maintaining decision-making capacity and efficiency». However, since the revision of 2014, the principles of corporate governance are «aimed at safeguarding *sustainable company interests*». And finally, since 2010 the UK Corporate Governance Code, which serves as a benchmark all over the world, makes the board responsible for the *long-term* success of the company, and not for the *success* of the company as before.

II. The system of the company limited by shares

The question now is whether our company law is organised in such a way as to enable this objective to be realised. In fact, when we examine the system relating to companies limited by shares, we notice something very odd: the decision-making bodies of the company are not all subject to the same regulatory system. The conduct of the board of directors and the management is subject to legal rules, as is to be expected and as is also obvious to every employee, in that they are obliged by the law always to act, with due diligence and in all conscience, in the best interest of the company. On the other hand, shareholders have no obligations to the company; their actions are driven purely by economics, and they may make all their decisions at the company's general meeting according to their own self-interest—without any consideration as to whether they will benefit or damage the company!

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One wonders how such a system can work with two different regulatory systems and why it does not collapse. The answer becomes clear under closer examination: the system works because (and as long as) it has two fixed anchor-points. The first anchor-point is that shareholders are long-term investors; the second is that legislators worldwide severely restrict the authority of the shareholders and locate the authority where the tasks and responsibilities are situated: with the board of directors and management.

The first anchor point is easily recognised in the SME or the family business: the company is run by the same owners for decades, and even generations. This results in a completely natural, parallel set of interests between the company and its employees, customers and suppliers on the one hand, and the shareholders on the other. The shareholders have a long-term economic interest in the company and therefore they are interested in its long-term success, and they make their decisions as shareholders accordingly.

The second anchor point may be a surprise if the shareholders are regarded as the owners of the company. However, it is important and there are consequences whenever shareholders neither see themselves, nor act, as long-term owners, but as investors who put money into the company in the form of equity (shares) in order to make a profit, just as they invest money in another company in the form of debt capital (bonds) from which they also want to achieve a return. This brings us to an important interim finding: unlike the SME or the family business, the public company shareholder, unless he is a core shareholder, should not be regarded primarily as an owner, but as an investor. The American authors Berle and Means pointed this out vividly as early as 1932 in their book «The Modern Corporation and Private Property»: «It is often said that the owner of a horse is responsible. If the horse lives, he must feed it. If the horse dies, he must bury it. No such responsibility attaches to a share of stock». And, hand on heart: do any of us regard our usually small exposures in European public companies as the involvement of responsible owners, or rather that of investors, interested in a good return and ready at any time to sell our shares, if we can make a nice profit or spot a better alternative?

III. New developments and their drivers

For 20 years or more, there has been a worldwide trend towards giving more power to shareholders in the corporate governance structure of public companies. The drivers of this development have been failures in leadership, the financial and economic crisis, excessive salaries, and last but not least the public and political perception of the shareholders as the owners of the company. Meanwhile, the public and the politicians were not fully aware of the fact that the shift of power in favour of the shareholders simultaneously entailed a shift of power from a legally controlled system into a purely economically determined one, and that in the case of public companies, unlike in family firms, there are no extrajudicial norms to control the behaviour of the shareholders with their increased power.

In parallel with this shift in power, there have been a number of changes in the composition and behaviour of shareholders in public companies. Thirty years ago, 60 to 80% of the shares in European public companies were directly owned by private individuals and companies. Today, 60 to 80% are held by so-called institutional investors such as pension funds, insurance companies, mutual funds and hedge funds. Thirty years ago, the majority of the shares in European public companies was owned by local citizens, now the majority is held by foreigners. Thirty years ago, the average time that shares were held was several years, and now it is just months. Today, there are more and more so-called activist shareholders whose only objective is a quick profit, and to whom the long-term well-being of the company in which they are investing is of no interest at all. Today, there are large sovereign wealth funds and other investors from countries such as China or the Arab states that are not open economies and that are based on an economic system that is different from that in the Western world. The sovereign wealth funds and investors from these countries have enormous financial resources that enable them to purchase many of the jewels of the Western industrial world on their ever bigger and faster shopping trips, without these states granting Western companies the reciprocal right to acquire companies in their countries.

IV. The strange new world of the public company

Since the public company system has been affected by the changes described in the power structures of companies limited by shares and in the composition and behaviour of shareholder populations, the modern public company finds itself in a strange new world. Today's public and government requirements are clear: the big, globally active, European companies are expected to live up to the principle of sustainability; they should be, and continue to be, global leaders in innovation; they should offer secure, well-paid jobs; they should be committed to corporate social responsibility; in short: they shall be committed to the stakeholder value principle, while at the same time create value for shareholders, employees, customers, suppliers and the public, and foster their long-term satisfaction and freely-given loyalty.

At the same time, however, the instruments that the law and established practice make available to business leaders to implement this challenging task are completely contrary. The quarterly report demanded by investors leads to constant high pressure from them, the media and thus the public, to achieve short-term successes and a rising share price. If a company's share price development lags behind its peers' for a couple of quarters, its executives are soon confronted with questions about their leadership skills and the effectiveness of their strategy. Activist shareholders enter the arena and require urgent measures to increase the share price, such as the sale of parts of the company, mergers or the return of equity to shareholders in order to increase the return on equity as a result of the reduction in capital. The public is happy to play along, without realising that the success of these activist shareholders is often at the short-term expense of the employees who are laid-off to reduce costs, and at the long-term expense of the company's innovative strength and thus its sustainable success. And if significant parts of an industry are acquired by Chinese companies, it doesn't bother us at all, as it opens up short-term market opportunities in big China. Meanwhile, we either don't notice or we don't care that the Chinese play the business game according to quite different rules, that their investments are strategically directed or co-directed by the apparatus of the state, that they snap-up specific Western know-how, that they think in decades and centuries and not in quarters like us, and that they keep the European company jewels that they acquire and never return them to the free market. On the contrary, we are all for it, arguing that European companies also acquire foreign companies—not perceiving the fact that, as far as China is concerned, the principle of reciprocity does not exist to any extent.

V. A broad socio-political discussion is necessary

There is a clear postulate from all of this: in Europe, we must conduct a broad socio-political discussion on our need for and on the meaning and purpose of sustainable economic activity. We must discuss the purpose of the public company: should it have obligations to all of its stakeholders or only to the shareholders? The debate about shareholder versus stakeholder value thus assumes a new, sharper relevance in the face of the recent developments described. We need to talk about the picture we have of a public company's shareholders: are they its responsible owners, or are they investors who do with it as they please? What is the role of shareholders in the modern public company? Is it necessary to differentiate between long-term shareholders and short-term investors? Does it make sense to put today's sweeping powers into the hands of activist shareholders? Does the free movement of capital, which is unquestionably important to the European economy, also make sense vis-à-vis those countries that do not operate according to the principle of economic freedom enshrined in European constitutions and which do not grant our companies reciprocal rights?

Ultimately, this complex issue can be reduced to a simple equation: many rights = many obligations; few obligations = few rights. It is necessary to choose between a form of corporate governance in which the shareholder has no obligations and consequently a limited legal status, and a different form of corporate governance, in which obligations are imposed on the shareholder in return for awarding him greater power in the structure of the public company.

Europe's lawmakers should grapple with these fundamental questions and the legislative implications resulting from the answers to them.