Tomorrow's Owners

Stewardship of tomorrow's company

tomorrow's company

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Foreword

The ownership of companies is a crucial subject. It is critical not only to the way companies are led and managed, but also to the impact they have on the world in which we live.

Hermes and Tomorrow's Company are delighted to have worked together on this first report, with Hermes as sponsor of the research.

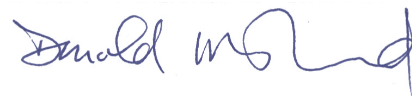
Hermes, itself owned by the BT Pension Scheme (BTPS), acts as the investment managers for the BTPS and has a proud track record of exercising ownership and stewardship responsibilities on behalf of BTPS and other clients.

Tomorrow's Company has a tradition of tackling the really difficult questions that business knows to be important, and doing so in a systematic way, bringing shared business values to bear in a spirit of openness and inquiry. From its first report – Tomorrow's Company: the role of business in a changing world (1995) – it has argued that the job of leaders is to create clear purpose and values and strong relationships with shareholders, employees, communities, suppliers and customers. The same holistic approach is evident in the conclusions of both its last two inquiries, Restoring Trust (2004) which examined the effectiveness of the UK investment system, and Tomorrow's Global Company (2007). Both emphasise the interdependence between the success of a business and the health of its surrounding environment, be it the investment system or society or the planet, and the importance of nurturing relationships which promote both.

In this report, which reflects several months of intensive work with leading players in the investment and finance industry, the process of nurturing and developing these relationships is described as 'stewardship'. The report raises a number of questions which we now intend to explore further, informed by deeper research and dialogue. The answers to these questions should help clarify the agenda in different parts of the world for the future regulation – or self-regulation – of the investment process, and for the choices made by companies in their investor relationships.

The subject of ownership needs this systematic and inquiring approach. As the report shows, ownership is not a simple concept, and it is neither accurate nor helpful to confuse ownership of shares with ownership of a company. Recent debates have been too full of investor class warfare – the branding as good or bad of whole classes of investment rather than seeking to understand and reinforce the positive parts that each may play. Stewardship is the concept that now needs to lie at the heart of these discussions.

Mark Goyder
Founder Director
Tomorrow's Company



Donald MacDonald
Trustee director
BT Pension Scheme Trustees Ltd

Executive Summary

What does ownership mean?

This report argues that the success of companies and the societies in which they operate depends on the exercise of 'stewardship'.

In Tomorrow's Company, we see stewardship as the process through which 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 well-being of the environment and society.

Although it has become routine to talk of companies' shareholders as their 'owners', it is important to clarify what 'ownership' means at the outset of this discussion.

In a technical sense, companies are separate legal entities which own their own assets. However, in practice, ownership consists of a 'bundle of rights' which are exercised to a degree by shareholders and to a degree by directors and by others. Directors are the effective controllers of companies, being entrusted by shareholders with the management of the company on a day-to-day basis. However, directors are accountable to shareholders and can be influenced by them to varying degrees – directly through engagement and dialogue or indirectly through shareholders' sentiment reflected in the share price.

The idea that the core responsibility for stewardship is shared between shareholders and directors is we believe, very important.

We believe shareholders have four main ownership-related roles, of which stewardship is the most important:

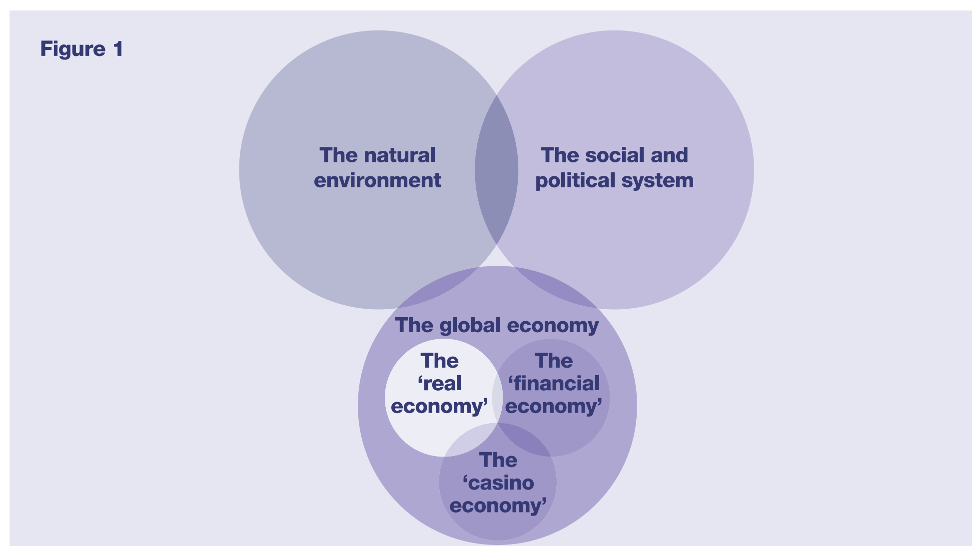
- **Member** – setting the rules, voting, attending the Annual General Meeting (AGM);
- **Analyst, or scrutineer** – assessing the company's potential and ability to deliver;
- **Financier** – providing equity funding in an Initial Public Offering (IPO) or rights issue;
- **Steward** – promoting sustainable, 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. This idea that the core responsibility for stewardship is shared between shareholders and directors is, we believe, very significant, with many implications for the relationship between the two groups.

How are ownership patterns changing?

Like all aspects of society, company ownership is being affected by the forces of globalisation and technology, together with competition for scarce resources and efforts to prevent damage to the environment. For example, globalisation and technology have encouraged new financial institutions and instruments such as hedge funds, derivatives and 'contracts for difference'. However, increasing awareness of climate change and political developments have reminded companies that they depend for their success on the health of three connected systems – the natural environment, the social and political system and the global economy.

The global economy can be seen as consisting of three 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.

This report touches on all three parts of the global economy – from the hands-on owner-proprietor or a family business (i.e. in the 'real economy') to pension funds representing millions (in the 'financial economy') to the transient owner of a complex derivative (in the 'casino economy').

Profound changes are now underway in the patterns of company share ownership, both in the structure of companies and the nature of their shareholders.

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The changing ownership landscape – company characteristics

The model of a company that is listed on a stock exchange and has widely dispersed shareholders may be dominant in the UK and U.S., but it is not the worldwide norm. For example companies with 'blockholders' – where a single owner has more than 20% of the shares – account for 60% of market capitalisation in Germany, France and Italy. Also, over time the balance between listed and private companies has fluctuated. Worldwide, most companies are unlisted. There is also 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.

Hedge funds, sovereign wealth funds and private equity are outweighed by a factor of ten by the world's pension funds, mutual funds and insurance funds.

The changing ownership landscape – shareholder characteristics

In terms of the shareholders themselves, there has been a shift in many developed economies from individuals to institutions. Individuals held over half of UK shares in 1963. Today they hold around an eighth. There has also been a rapid increase in foreign shareholders. For example, in the UK, foreign investors held less than a sixth of the shares in 1993; but by 2007, the government was reporting that foreign ownership of the UK quoted corporate sector had reached around 50%. Domestic institutions such as pension funds and insurance companies held over a half of UK shares around 1993. Today their share has slipped back to around a quarter.

In spite of the attention given to hedge funds, sovereign wealth funds and private equity, they are outweighed 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 are also being held for shorter periods, although this could arise from some shareholders churning shares faster and faster while others maintain long-term ownership.

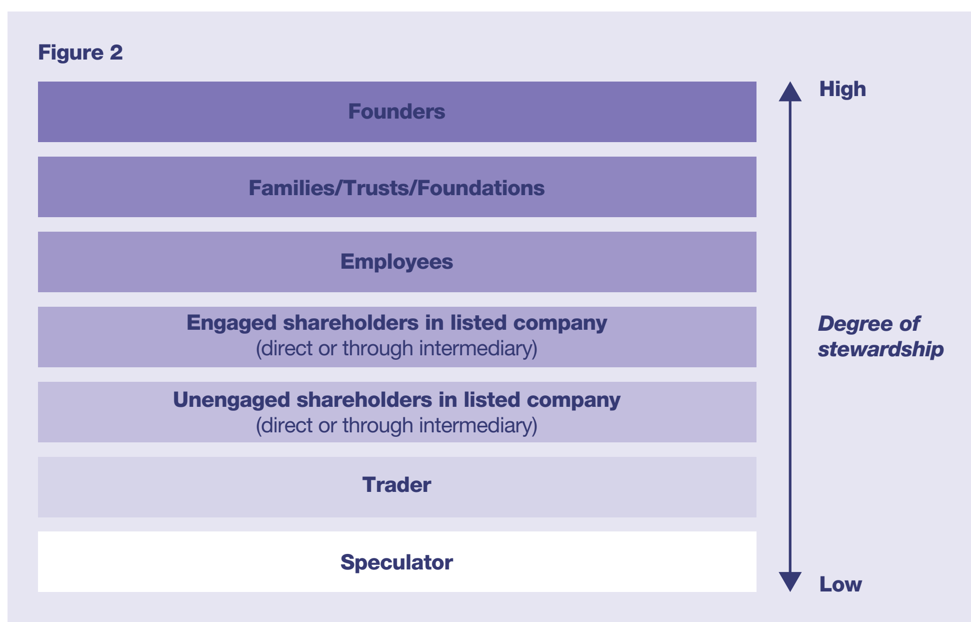
The array of investors and their behaviours

It is inappropriate to categorise whole types of investors as either 'good' or 'bad'.

It is inappropriate to categorise whole types of investors as either 'good' or 'bad'. Nor is the issue one of 'owning' versus 'trading': a healthy economic system will always contain both elements. Our concerns for the future are about stewardship behaviours and the extent to which shareholders are aligned with the long-term interests of the company.

We have plotted what we have learned about the behaviour of different types of shareholders and their tendency to exhibit the quality of stewardship along something we have called the **stewardship spectrum**. Figure 2.

Figure 2



The position of different shareholders along the spectrum is not absolute. But this 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 of the spectrum, speculators exercise no stewardship responsibilities whatsoever.

Private equity

In the U.S. private buyout activity has grown from $24.6 billion in 2000 to $356.7 billion during the first 11 months of 2007.

While private equity (PE) firms have been widely criticised, for example, when seen as asset strippers, they can also be seen as the ultimate form of shareholder stewardship when they take over companies with a view to turning their performance around. Defenders of PE say that it tends to restore the links between ownership, financing, control and stewardship of a company. However, in many cases the priority is a profitable exit within around five years and others have pointed out that while PE firms may be loyal to the companies they buy, they may not have such a strong loyalty to other stakeholders.

Hedge funds

Globally assets under management of hedge funds have trebled in five years to a record $2,250 billion in 2007.

Hedge funds have become highly influential over the past decade, associated with particular controversies such as those over shortselling and the use of contracts for difference. However, hedge funds can be positive for the economy in their role as 'scrutineer' where they highlight deficiencies or benefits. There are some socially responsible hedge funds, and some of these use short selling to send messages to the companies about their behaviour and impacts.

Sovereign wealth funds

It has been predicted that SWFs by 2013 will control $15-20 trillion.

Sovereign wealth funds (SWFs) have also grown rapidly in influence, many buoyed by strong oil and other resource revenues. There have been concerns about their political motivation but they have more recently been welcomed as saviours of the western banking system. A significant number of SWFs are in the process of finalising a set of voluntary principles and practices. So far, SWFs appear to be behaving as patient long-term owners with dispersed but stable holdings and a focus on enduring financial returns. They therefore fit the classic mould of responsible investors, or 'stewards'.

Institutional investors

Institutional investors remain the giants of the investment community.

Institutional investors remain the giants of the investment community although their dominance is being challenged by newer owners. Some are commonly perceived as the source of short-term, financial pressures on companies. Others are seen as long-term, loyal, shareholders who seek deep knowledge of companies in which they invest. Many have fiduciary responsibilities to act in their clients' interests and these are often interpreted in terms of short-term financial return – yet their liabilities can stretch out 30 years.

Families, employees, foundations and others

Family-owned businesses are estimated to produce nearly 60% of global GDP.

Families which own or run their businesses for generations clearly have an inbuilt motivation to create the long-term value that constitutes one aspect of stewardship. When family businesses are listed there can be conflicts of interest between members of the family – who may own the majority of the shares – and the minority shareholders.

Employee-owned companies are rarer but include successful and well respected businesses. The Mondragón Cooperative Corporation is now the Basque Country's largest corporation and the seventh largest in Spain. Stewardship tends to come naturally to employee owners, who want their company to be respected and long-lasting.

Foundation-ownership is found mainly in Northern Europe – particularly in Denmark, Germany, Sweden, Norway, the Netherlands, and Switzerland. Examples include Bosch and Ikea. This approach has usually been driven by a desire to safeguard the long-term future of the company and – in many cases – to maintain the vision of a founder.

What do these changes mean?

Our research has raised a number of questions about what the differing approaches to ownership portend for the financial system, for society, for companies and for policymakers and regulators. These questions will inform the dialogue, research and agenda-setting in the next stage of *Tomorrow's Owners*. We believe there are three major, overarching questions to be asked – about the social and environmental roles of companies; about alignment between investors and companies; and about regulation and other frameworks that direct the market. These then prompt some more specific questions.

Can the global economy be a positive force for the natural environment and for social and political systems? Or is there a growing risk that speculative activity in the 'casino economy' will result in needless wealth destruction and leave social and environmental challenges unaddressed?

If the activities of the 'casino economy' grow disproportionately strong, they may undermine the ability of companies to sustain themselves over the long-term…

Many shareholders are now buying into a broad and sustainable vision of success. This is typified by such initiatives as the Principles for Responsible Investment with its rapidly growing membership. However, there are also shareholder pressures that can lead companies to adopt a less sustainable approach. Companies can be distracted by speculation. There is a fine line between legitimate trading – which helps ensure open, liquid markets – and market abuse. Liquidity is one precondition for success of the economy and society, but another is the appropriate balance between the strength of the 'real', 'financial' and 'casino' economies. Some of the wider issues facing society, for example, the economy and the environment, require concerted action in which companies will play a central part. These take time to resolve. If the activities of the 'casino economy' grow disproportionately strong, they may undermine the ability of companies to sustain themselves over the long-term and to play their full role in addressing these problems.

So how can the right balance of behaviours be achieved?

There is a lack of alignment between the interests of some investors and companies. So who should adapt: companies, investors, or both?

Will companies need to adapt?

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 to a long-term intrinsic investor?

Today, when companies have an array of different shareholders with differing motives, they can no longer treat all investors the same. 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 to a long-term intrinsic investor? In this changing environment, CEOs can be proactive in deciding which of their owners are truly aligned with their long-term interests and using their influencing skills to build the confidence of those core investors.

So, should companies raise their game in terms of investor relations, being more proactive in seeking out and engaging with their major shareholders – going beyond fund managers in doing so?

Or will the attitudes of investors change?

As public pressure and concern grow about social and environmental impacts, this will have an effect on the way a company is valued. 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. Investors can also learn from each other. 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. Specific questions in this area include:

When pension funds and other institutional investors invest in hedge funds – or indeed private equity – should they be better at setting mandates which hold those investment vehicles to account? And what should the institutions do to ensure that the methods used by those they invest in do not contradict their own purposes as custodians of their members' savings? Furthermore, should they not ask whether their stock lending is justified in the light of their overall objectives?

We have noticed that talk of 'shareholder activism' is now being supplemented by discussion of 'stakeholder activism' – but perhaps in years to come, we will talk instead, of 'stewardship activism'.

What regulation or frameworks are needed to underpin stewardship to support global growth and help companies address sustainability issues?

As each new class of investor grows in influence, with activities that are often not open to public scrutiny, there quickly follow calls for mandatory regulation, or at least for new frameworks for self-regulation. A balance needs to be struck between the right of a company to know who owns its equity and the right of an investor to pursue a value-creating strategy in confidence, without sharing the information and thus the rewards with the rest of the market. However, generally, the principle of stewardship is advanced by greater openness, and regulators in the U.S. and the UK have recently signalled agreement with this by tightening regulations on disclosure thresholds. A specific issue we have repeatedly encountered in discussion over this area is that of shares being borrowed for trading or speculative purposes, or for use in order to gain voting rights. Specific questions in this area include:

Can regulators and the law continue to treat all types of investor in the same way? Is greater regulation justified, and if it is, what should these frameworks look like? What is the right balance between transparency and confidentiality – and what, if any, further regulation is needed to strike that balance?

Can regulators and the law continue to treat all types of investor in the same way?

Is more regulation needed to prevent market abuse? Or should markets be allowed to operate freely whilst authorities encourage the establishment of voluntary frameworks on a global basis? Will the fallout from the sub-prime crisis result in new frameworks being created, whether voluntary or imposed? How effective and how widely adopted are the various codes for self-regulation?

What does stock-lending do for the concept of stewardship? For the pension fund, is the practice justified by the fee income derived from it – or should wider stewardship considerations apply? Should investors be allowed to vote on critical issues when they only hold borrowed shares?

As competition is intensifying for sources of energy, raw materials and water, so foreign ownership of key industries and infrastructure assets is increasing – by SWFs in particular. Whether this is of concern or not to the countries affected will depend on the motives of the new owners – motives which, as we have noted, are not always made known. Some countries will be affected favourably, others less so.

Is it now necessary to reassess the case for public (state) ownership of strategically important industries?

Countries have every right to safeguard national security and protect themselves against excessive dependence – but is this anxiety being used as an excuse to engage in broader protectionist policies? In light of these fears, is it now necessary to reassess the case for public (state) ownership of strategically important industries?

Meanwhile large companies are becoming global citizens; locating according to business logic, registering where the tax and regulatory regimes suit them, accepting investment from the most convenient source, and recruiting talent, and frequently customers, on an increasingly global basis.

So does the country of origin of a company's ownership matter any more, other than in the case of defence industries and other nationally strategic industries where interruption of supply could be jeopardised by foreign ownership? On the other hand, could foreign ownership become a guarantee of economic interdependence and therefore of peace? Are there implications for regulators in the future?

Can a shared view of shareholder democracy be reached? And how this might be addressed through regulation or other means?

Another significant issue for regulators in the future is the balance of power between different investors and directors, and the rights accorded to shareholders in different jurisdictions. The risk in the dispersed shareholding model is that directors can be too free to serve their own interests at the expense of the company and its shareholders. Equally in the blockholding model, minority shareholders are often denied the rights they need to give them a fair voice to hold directors to account. These issues have prompted much debate, for example, in the European Union (EU).

So, can a shared view of shareholder democracy be reached? And how might this be addressed through regulation or other means?

Looking ahead

With every new intermediary in the value chain that links savers to investment performance, there is an inevitable erosion of the sense of stewardship. In the global investment landscape, the value chains are now heavy with intermediaries, some of whose motives are unclear and some of whose activities can be destructive to long-term wealth creation and sustainability. As the casino economy develops, a conscious effort is needed to review its impact on the rest of the economy, and on the health of the society and the environment on which we all depend.

In undertaking this review we need to move beyond the sterile business of demonising particular categories of investor and develop a new focus on what it really means in practice to provide for and encourage stewardship. Among other things, this may well mean an end to the assumption that all investors can be treated in the same way, by companies or regulators.

Stewardship of our companies is a part of stewardship of our future well-being.

We need to encourage and support those investors who do acknowledge the importance of stewardship. Stewardship of our companies is a part of stewardship of our future well-being.

Part 1: Introduction

How companies are run matters to all of us…

Why ownership matters

Companies, particularly large ones, have wide-ranging impacts on our lives: they provide us with goods and services; they provide millions with jobs; they play roles in public services such as education and health; we entrust our savings to them. In sum, they enter into almost every aspect of our lives.

How companies are run, therefore, matters to all of us and we should have an interest in who owns and controls them. Those who control companies can decide what they make, what they do, where they work and whom they employ, as well as issues such as what values they have, how they treat their employees and suppliers and whether they seek to play a positive role in society as a whole.

For Tomorrow's Company, there is a logic in focusing specifically on the issue of ownership. It has been a recurring motif in our work, in particular in our last two major inquiries:

- ***Restoring Trust (2004)*** – which examined the effectiveness of the UK investment system; and
- ***Tomorrow's Global Company: challenges and choices (2007)*** – which explored the future role of global business.

Many of our members and those who have taken part in these inquiries have emphasised how changing patterns of company ownership are having major impacts within their companies and in their relationships with external stakeholders.

In *Restoring Trust*, it was argued that – while the system is relatively robust and long-term investors and short-term dealers both have a place in a balanced market – there were some ownership-related issues that needed to be addressed, for example:

- Business needed to be conducted transparently in order to promote trust and confidence;
- CEOs needed to 'combine managing the future with managing the present' and, while needing to retain the confidence of the markets, not allow the pressure of the markets to deflect them from laying the foundations for long-term value creation. The Inquiry Team saw a need for companies to be bolder in setting out their long-term strategy and in initiating a deeper and more strategic dialogue with their investors;
- Despite the encouragement of government and others, many of the fiduciaries representing companies' largest shareholders had largely abdicated their responsibilities as the representatives of those companies' owners.

These findings were echoed by the Inquiry Team, made up of senior leaders from business, civil society and NGOs, who carried out the *Tomorrow's Global Company* inquiry. They summed up the purpose of a business as:

> ***"To provide ever better goods and services in a way that is profitable, ethical and respects the environment, individuals and the communities in which it operates."***

The Inquiry Team said that to fulfil this purpose, companies needed to have strong values, define their success in terms of lasting positive impacts for shareholders and society, and work with others to create better frameworks to direct the market.

In addition:

- the Inquiry Team reasserted their belief in a strong market economy but added that the frameworks in which the market operates were inadequate and leading to unsustainable outcomes;

- The report said that global companies could be a force for good, being uniquely placed to deliver the practical solutions that are urgently required to address major issues. To play their full part, they first needed to maintain their own economic health by retaining the support of customers and shareholders. From this position, they could build stronger and more constructive relationships with governments and civil society in a joint effort to deliver the solutions that are needed;
- Providing returns to investors and ensuring the future health of the environment and society were not at odds with each other. Open and honest communication is key to gaining support of all stakeholders and building the trust required to work towards a more broadly defined vision of success;
- One critical factor holding companies back from defining success in a broader and more long-term way was the pressure – sometimes real and sometimes perceived – to deliver short-term results to please impatient investors. However, the team also believed that the market would ultimately reward those who set and explain long-term goals in building sustainable businesses of lasting benefit to society. In the financial markets, according to the report, growing numbers of players were attaching importance to social and environmental impacts and this should encourage companies to be much bolder in describing long-term strategy and explaining their short and medium term performance in that context.

Both inquiries placed great emphasis upon the role of leaders in enabling a business to accomplish its purpose. However, the ability of leaders to fulfil such an agenda is itself heavily dependent upon their relationships with investors. Do their investors encourage or discourage such a role? Do they share the company's sentiments about sustainability? Or do they just want to see an increase in the next quarter's earnings, regardless of social and environmental issues other than legal compliance?

To answers some of these questions, Tomorrow's Company has been developing a specific programme of research into ownership.

Our approach: some initial observations

In looking at ownership as a subject in itself, the temptation is to focus on the burning issues of the moment – such as hedge fund profits, short selling, the latest private equity buyouts or sovereign wealth fund acquisitions.

However, for this programme to have validity, it needs to take several steps back and draw out some fundamental principles about ownership before considering today's controversies in that wider and deeper context.

We believe it is pertinent to ask a number of basic questions about ownership: What does ownership mean? Who actually owns companies? And who is in control? In whose interests is that control exercised? And for what purposes?

What are the implications of changing patterns of ownership for other factors in the business and political systems? – for wealth creation; wealth distribution; national economies; national security; and internal factors such as governance and stakeholder relationships? What are the implications for wider issues such as the environment, climate change and world poverty?

These questions can be summed up in two broader ones: **How are ownership patterns changing?** and **What do those changes mean?**

There are also a few assumptions we need to challenge at the outset. For example, we are conscious that much commentary has implied that a company's shareholders are its owners – that the terms and roles are synonymous. But shareholders do not own companies in the same way that people own their homes or clothes. Ownership is a complex concept. Shareholders enjoy many of the rights of owners – but it is important to understand what these do and do not include – which is why we devote a section to what ownership means and the particular role of shareholders.

Much of the debate, certainly as seen from a UK viewpoint, has also focused on the behaviour of shareholders in listed companies. Key issues include how long they hold their shares for, in which companies they invest and the extent to which they engage with directors. But most of the world's companies are not listed. There are many different models, from family firms and employee-led co-operatives to state enterprises to private equity managed companies. A discussion of ownership in Delhi or Beijing will be different from one in New York or London. However, it will not be totally different because in a global economy, these cultures and approaches are becoming interwoven and our analysis needs to take account of this. In this report, we therefore use the word 'shareholder' broadly – not only relating to shareholders in quoted companies, but also encompassing state shareholders and shareholders in private companies, including families, private individuals, partners, employees, members, trusts and foundations.

So this programme is looking across the broad canvas of the business world to draw out the main changes in ownership and their implications.

The report you are now reading is an initial scoping study for a more detailed programme of research. It is designed not to provide answers or firm recommendations, but to identify the most important issues and clarify the terms of the debate. We have spoken to many people involved in different aspects of ownership in order to understand the views and motivations of different players.

In terms of structure, the report starts by setting out the global context for this programme – then goes on to consider the nature of ownership, the role of shareholders as owners, and the extent to which they control companies. After reviewing data on key changes in ownership, we examine different types of investors in turn before looking at the implications of the current changes for companies and society.

Part 2: The context

The health of enterprises, savers and society all depend on a balance of behaviours between the natural environment, the social and political system and the global economy.

The global context

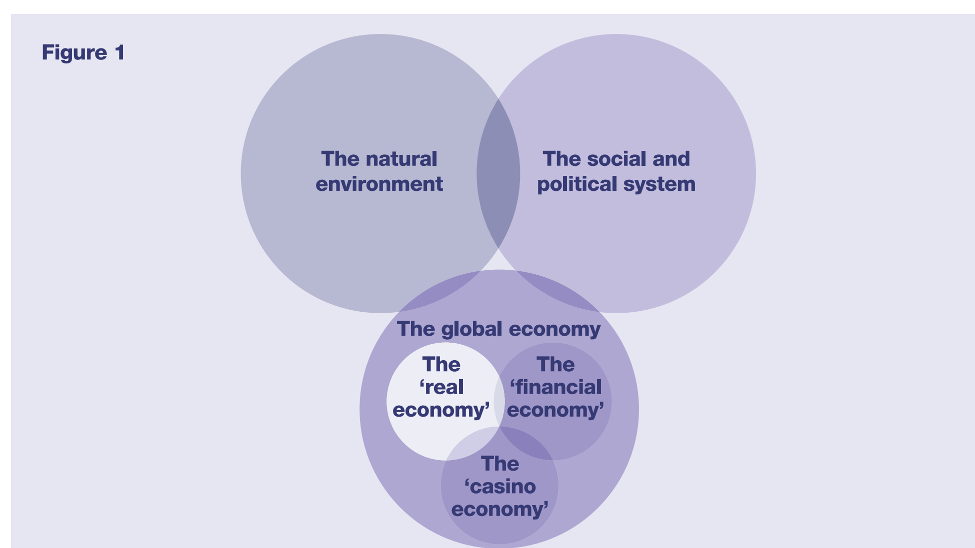
Discussion of company ownership, like discussion of any business issue, cannot be undertaken without recognising the context of massive global change in which it takes place. Ownership changes, in common with other types of changes in business strategy and behaviour, are being affected by the forces of globalisation and technology as well as the effort to overcome pressure on resources and damage to the environment. The effects of these changes on the subject of this programme can be summarised as follows:

- The accelerating globalisation of economic and social life has led to the rapid growth of emerging economies, particularly large ones such as China, India, Russia and Brazil. This is driving a shift in wealth towards Asia and increasing the number of people with sufficient resources to invest in companies;
- At the same time, demand for oil and other scarce commodities is driving a shift in wealth towards resource-rich countries;
- The growth in consumption and industrialisation has had many environmental impacts including the build-up of greenhouse gases in the atmosphere which threatens to create dangerous levels of global warming. This has led to questions about responsibility for addressing the issue and the basis on which to assess the performance of companies;
- Technology has transformed social and economic life. It has encouraged newer types of financial institutions and instruments such as hedge funds, derivatives and 'contracts for difference';
- Instant global communications have also intensified the scrutiny to which politicians and businesses are subjected, increased the speed at which markets can react to changes in a business' strategy or operations and heightened societal awareness and concerns over a range of business related issues ranging from human rights to executive pay.

The system context

In the *Tomorrow's Global Company* report, we set out a way of visualising the complex global system on which companies depend for their survival and success. This system involves three interdependent sub-systems – the natural environment, the social and political system and the global economy. A failure in one can cause severe reverberations, or even collapse, of the others.

This report focuses on some of the trends and pressure points in one of those sub-systems – the global economy and what we see as the three sub-systems within it – all of which are interrelated, as shown in Figure 1:



- The **‘real economy’** – the operations of organisations which produce goods and services that meet an actual human need.
- The **‘financial economy’** – the operations, accountability and regulation of the intermediaries that provide the financial support to the ‘real economy’ – such as the banks, fund managers, brokers, analysts etc.
- The **‘casino economy’** – a term that has come to describe the activities of those linked to the ‘financial economy’ but whose activities and motives are removed from the production of goods and services and where the prices set may have little relation to the underlying values of what is being traded. It is a system in which profits are made from expertise in the manipulation of financial instruments such as derivatives rather than from producing goods and services or providing the financial services to support their production. It is a world that has grown rapidly since the mid 1980s, centred mainly on the financial centres of London and New York.

The issues being explored in this report relate to all three parts of the economy – from the hands-on owner-proprietor or a family business, to pension funds representing millions, to the transient owner of a complex derivative that has distant relationships to hundreds of companies.

To put the different parts of the system in perspective and to indicate their relative size to each other, in 2007:

- The World Trade Organisation estimated the value of world merchandise exports at $13.6 trillion, and commercial services at $3.3 trillion;[1]
- However the Bank for International Settlements estimated the notional amounts of all categories of over-the-counter (OTC) contracts at $596 trillion at the end of December 2007.[2&3]

Our perspective is that the health of enterprises, savers, and society all depend on a balance of behaviours between the natural environment, the social and political system and the global economy.

Our perspective is that the health of enterprises, savers, and society all depend on a balance of behaviours between the natural environment, the social and political system and the global economy.

Some of the issues that we face require concerted action and time to address and resolve. If the activities of the ‘casino economy’ within the global economy grow to such an extent that they begin to dominate the system, they may undermine the ability of companies to create and sustain themselves over the long-term and to play their full role in addressing the problems that society faces.

Disquiet over the disconnect between these parts of the global economy is nothing new. In 1893, Karl Marx said:

> *“(To the possessor of money capital) the process of production appears merely as an unavoidable intermediate link, as a necessary evil for the sake of money-making. All nations with a capitalist mode of production are therefore seized periodically by a feverish attempt to make money without the intervention of the process of production.”* [4]

What is new is the sheer scale of growth in the trading of financial instruments. Nowadays just about anything with future cash flows is being securitised as paper claims and traded, for example mortgage-backed securities that are traded in secondary markets. Likewise in financial instruments, contracts have been developed that are underpinned in value by some abstract entity – as in the case of stock index futures which are based on a statistical index of share prices.

“The bright new financial system, with all its talented participants, with all its rich rewards, has failed the test of the marketplace…”

The avowed purpose of securitising tangible assets for the purposes of trading is to reduce transaction costs and enhance liquidity in the markets. However, events such as the U.S. sub-prime mortgage crisis have dramatically shown how problems can be transferred between the three sub-systems of the global economy. Paul Volcker, former Chairman of the U.S. Federal Reserve System, said:

> *“The bright new financial system, with all its talented participants, with all its rich rewards, has failed the test of the marketplace…a demonstrably fragile financial system that has produced unimaginable wealth for some, while repeatedly risking a cascading breakdown of the system as a whole, needs repair and reform.”* [5]

The International Monetary Fund (IMF), in its April 2008 *Global Financial Stability Report (GFSR),* spelt out how a large overhang of ‘virtual’ money can exacerbate the downs of the economic cycle and convert losses made in the ‘casino economy’ into impacts on the ‘real’ world of homes, jobs and incomes:

> *“Macroeconomic feedback effects are also a growing concern. Reduced capital buffers and uncertainty about the size and distribution of bank losses, combined with normal credit cycle dynamics, are likely to weigh heavily on household borrowing, business investment, and asset prices, in turn feeding back onto employment, output growth, and balance sheets. This dynamic has the potential to be more severe than in previous credit cycles, given the degree of securitization and leverage in the financial system. Thus, it is now clear that the current turmoil is more than simply a liquidity event, reflecting deep-seated balance sheet fragilities and weak capital bases, which means its effects are likely to be broader, deeper, and more protracted.”* [6]

The interplay between the three sub-systems within the global economy is an important part of the backdrop to this programme.

During the course of this report other issues are raised which relate to the concept of the three interrelated economies. For example, there are concerns over the way that money which originates in the ‘real economy’ as a part of people’s wages not only finds its way to the ‘financial economy’ when it is deposited in pension funds but thence into the ‘casino economy’ – for example, if pension fund’s shares are lent to a short seller. Other concerns include those around the influence of private equity buyouts – essentially players from the ‘financial economy’ taking a decisive role in the ‘real economy’.

And having set out the context, it is time to revisit the fundamental nature of company ‘ownership’ and ask – what it means?

Part 3: What does ownership mean?

Ownership has become more complex. The core responsibility for stewardship must be shared between shareholders and directors.

However, over the years, ownership has become more complex.

The language of ownership

According to the Shorter Oxford Dictionary, the verb 'to own' comes from the Old English 'agan' and originally meant one of two things – either (first) *"to make a thing ones own; to seize, win, gain; to adopt as one's own"* or (second sense) *"to have or hold as one's own, or to have as one's function or business"*. 'Own' was scarcely used until the 17th century and the dictionary tells us that up to that point the usual word to describe the second sense was "owe".

The origins of the Anglo Saxon word 'own' are therefore the same as the word to 'owe'. To own something once meant to acknowledge it as both your property and your responsibility. However, over the years, ownership has become more complex. If we think of objects we 'own', what are our rights or responsibilities in relation to them? We are entitled to the value of the object, but cannot control that value. We can't even use it as we like, as the law prevents some uses and our own values will prevent others. We can give it away. Equally we are responsible for the possession. For example, if a car breaks down at the side of the road, the owner cannot simply abandon it without facing legal consequences.

The lawyer and academic A.M. Honoré has advanced what is often regarded as the definitive description of ownership, setting out a bundle of rights and duties associated with the concept. He described these as:

- the right to possess
- the right to use
- the right to manage
- the right to income from the possession
- the right to the capital
- the right to security
- transmissibility (the right to transfer the possession to someone else)
- absence of term (the right to hold the asset without time limit)
- the prohibition of harmful use
- liability to execution (seizure of the asset to pay unpaid debts) and
- residuarity character (meaning that the owner's rights are residual in that they consist of all rights not conceded to someone else).[7]

The *OECD's Principles of Corporate Governance*, published in 2004 discussing rights of shareholders as owners, reinforces the idea that 'ownership rights are residual rights' and simplifies them into two areas:

> *"Ownership consists of two main components: the right to income and the right to control. The owner of an asset has the right to the income produced by that asset, after paying out the part of income that has been contractually promised to outside parties. The income right is thus the right to the residual income. A joint-stock company must first pay off banks and bond-holders to whom it owes money, and the owners – the shareholders – then receive the net income. The owner bears the risk of loss and enjoys higher income if profits increase. The right of physical control is also residual, in the sense that control of the asset may be limited by contract or public regulation, but the owner has the right to decide what happens to an asset after all the contractual obligations are fulfilled."*[8]

The relationship between shareholders and companies

So do shareholders have all the rights and duties regarding companies as listed by Honoré? Do these come down to rights to residual income and physical control of assets?

When we have sought to discuss 'ownership' with leading figures in business and finance, they have immediately started to discuss different types of shareholder and shareholder behaviour – on the assumption that 'shareholders' are synonymous with 'owners'. Is this a valid assumption?

Technically a company is a separate legal entity which owns its assets and in whose interests directors have a fiduciary duty to act. The company has various contracts and relationships with suppliers, customers, governments and society – all of which can influence the decisions made by the directors of the company.

There is an assumption that 'shareholders' are synonymous with 'owners'. Is this a valid assumption?

While shareholders own shares – the equity in the company – it has been argued by some that they do not in any meaningful sense 'own' the company. As John Kay has pointed out, shareholders own shares in BT – in the sense that all the Honoré criteria of ownership are met in respect of the shares – but do they 'own' the company in the same sense? Their shareholding gives them no right of possession or right to use the company's assets. If holders of BT shares go to a telephone exchange, they will be turned away at the door.[9] When shareholders challenged the appropriation of a company, the courts ruled that *"shareholders are not, in the eyes of the law, part owners of the undertaking"*.[10]

Table 1 below shows how John Kay summarised how the different rights and duties as described by Honoré apply to shareholders in respect of the shares that they own (me and my BT share) and in respect of the companies in which they hold shares (me and BT).[11]

Table 1
Application of Owner's Rights and Duties

Characteristic	Me and my BT share	Me and BT
the right to manage	Yes	Partial
the right to possess	Yes	X
the right to use	Yes	X
the right to income from the possession	Yes	Partial
the right to the capital	Yes	Partial
transmissibility (the right to transfer the possession to someone else)	Yes	X
the right to security	Yes	X
the prohibition of harmful use	Yes	X
liability to execution (seizure of the asset to pay unpaid debts)	Yes	X
absence of term (the right to hold the asset without time limit)	Yes	Yes
residuarity character (meaning that the owner's rights are residual in that they consist of all rights not conceded to someone else)	Yes	Yes

As can be seen from his analysis, shareholders have all the rights and duties in relation to owning a share but only some in respect of their relationship with the companies in which they are shareholders. The mechanism through which the right to manage is exercised is voting rights.

The decisions of shareholders can affect whether the company's assets are used well or harmfully but the directors of a company are the de facto stewards of the company, acting as agents of the shareholders.

Dow Votaw, echoing Honoré, expresses the shareholder's ownership rights as follows:

> *"Property consists of a bundle of rights which the owner of property possesses with regards to some thing – rights to possess, use, dispose of, exclude others, and manage and control. The corporate concept divides this bundle of rights into several pieces. The stockholder gets the right to receive some of the fruits of the use of property, a fractional residual right in corporate property, and a very limited right of control. The rights to possess, use, and control the property go to the managers of the corporation."* [12]

While some ownership rights lie with shareholders, others have some rights as well. Stakeholder rights may be through contracts, such as a contract between the company and a supplier, or through other means such as legislation, which affect the shareholders' residual rights of income and asset control.

The decisions of shareholders can affect whether the company's assets are used well or harmfully but the directors of a company are the de facto stewards of the company, acting as agents of the shareholders. They shape the plans and direction for how the company will survive in the short-term and sustain itself over the long-term.

Moving from the technical and legal concepts into the practical ways in which shareholders can exert their influence within the company context, we have identified four main roles which shareholders perform:

- **The shareholder as member** – agreeing the articles of association, setting the rules, voting in some instances, having the right to attend the AGM;
- **The shareholder as analyst or scrutineer** – assessing the company's potential and the ability of management to deliver. For many investors, the analysis does not go beyond the financial aspects of a company's performance, although analysing environmental, social and governance issues is becoming more common. For many directors this is the critical shareholder role as it largely determines whether shareholders buy, sell or hold their stock. It thus determines the share price on which depend the fortunes of the company and of the directors whose remuneration packages typically include share options;
- **The shareholder as financier** – providing equity funding at the time of an IPO and responding to rights issues. Shareholders at annual meetings may be gratified to hear the chairman deferentially talk of 'your company'. CEOs in a tight spot over issues such as executive pay or lay-offs frequently emphasise their duty to shareholders as owners. The implication is that the company is supported and sustained by shareholders' funds. In fact owning a share has little to do with financing investment other than at the times of an initial offering or a rights issue. Investment by a company is mainly sourced from its cash flow, by gearing using bank borrowing or by corporate bond issues. Peoples' savings provide little of the capital for investment but these savings are at risk if companies do not perform;
- **The shareholder as steward** – acting to preserve and protect the company, promoting sustainable, long-term, performance.

We must add that in each of these roles the shareholder is not acting in isolation, because directors, governments, bondholders, banks and other lenders are also involved in exercising these functions. In Tomorrow's Company, we place particular emphasis on the last role. We see 'stewardship' as the process through which shareholders or others seek to influence companies in the direction of long-term, sustainable, performance that derives from contributing to human progress and the well-being of the environment and society. In exercising their influence shareholders, directors and others apply their own values.

In other words, stewardship of a company is what is necessary for it to succeed sustainably, in the way envisaged in the Tomorrow's Global Company inquiry – by defining its success in a broad and long-term way, by having strong values and by actively encouraging frameworks being set around the market which direct its operation towards sustainable ends.

The rights and duties of shareholders give them a stewardship role alongside that of directors. The idea that the core responsibility for stewardship is shared between shareholders and directors is, we believe, very important in today's climate. It forms a basis for looking at specific events – asking whether shareholders, on one hand, and directors, on the other, are acting as stewards.

The idea that the core responsibility for stewardship is shared between shareholders and directors is, we believe, very important in today's climate.

So while the concept of ownership is a complex one and its various rights are exercised by a diversity of players, there is a very widely held view that shareholders are in many senses (if not a strict legal one) 'owners' of companies. This is why we proceed on the basis that shareholders can indeed be described as 'owners' – in spirit, if not in letter – but why we also see their stewardship role as needing to be exercised in close association with the stewardship responsibilities of directors.

In fact 'ownership', while technically inaccurate or only partially accurate, is an excellent word to convey the stewardship dimension of share ownership because it carries with it, layers of meaning accumulated over centuries, relating to rights and responsibilities such as the duty of care.

Who controls a company?

So we have identified the broad roles that shareholders can perform and highlighted the importance of stewardship.

But in practice, who actually calls the shots? Who is in control?

Some say directors inevitably have hands-on control, particularly CEOs and executive directors, because they manage the company day-to-day. But in fact, directors are subject to a number of constraints besides the activities of shareholders in their exercise of control over the affairs of a company. These include company law, regulation, competitors' actions and the activities of trade unions.

The degree of influence that shareholders exert lies largely in their own hands, though in practice, different models have evolved in different countries, giving shareholders differing levels of authority.

The dispersed listed model has evolved to become a familiar structure for major companies in North America and Europe – and many believe it represents the purest and most effective means of distributing resources and driving efficiency. But it is a mistake to believe that it will inevitably come to reign over the world's business landscape through market forces or a process akin to natural selection. Globally, the dispersed model is not the norm. Most companies are private ones. Many public companies have dominant blockholders. And even where the quoted, dispersed model exists, there are contrasts in the pattern of shareholdings. Neither is the dispersed model necessarily the best. Studies have shown that companies with concentrated ownership through blockholdings, especially more than one blockholding, can often prosper by comparison with companies that have widely dispersed ownership.[13]

In countries, such as the UK and U.S., where listed companies have widely dispersed shareholdings, some of the four roles of shareholders can tend to be either diluted or neglected.

By contrast, in many companies around the world, there are one or more major blockholders, such as foundations, families or banks, who are deeply involved with the company and therefore exercise all four roles very actively. This is often the case, for example in continental Europe. Typically, shares are divided into voting and non-voting shares and substantial influence is exercised by the shareholder or shareholders owning the majority of the voting shares. The 'A' shareholders appoint the chairman and CEO and will normally be represented on the Board, while the owners of 'B' shares do not get a vote but get a share of the economic benefits. But in these cases, the fear is that the blockholder may benefit at the expense of the minority shareholders.

While blockholders with substantial holdings can influence a company purely through their voting strength and influence, minority shareholders with smaller stakes can exercise considerable influence through engagement and dialogue, activism, campaigning and generating publicity. These range from activists with a purely financial motivation who may campaign for or against mergers, acquisitions or other moves, to NGOs who take stakes in companies to protest at their activities.

David Jackson, Company Secretary of BP, told us:

> *"I see at least 3 sides to activism:*
>
> - *There is 'issue activism' where investors want something changed;*
> - *There is 'engagement activism', where shareholders buy a stake and actively engage with a company, but don't go public, like Hermes;*
> - *Then there are the hedge funds. Some often want to make money out of movements in the company's share price as a result of their activism. They say they want improvements in governance, but really they are using their activism to create reaction in the market and often the share price reacts when it is announced in the press that they are involved. They rarely engage the company first before going public. Once they have made their money they tend to move on."*

Our research has revealed wide variations in the rules that govern relations between company and shareholders in different countries.

In general, when there is one shareholder or a close knit group, such as a founder or family with a majority stake, ownership and control are aligned. However, when there are multiple shareholders, with different motives, their ability to exercise influence is inevitably diminished, as it requires considerable effort and resources to co-ordinate their views. Control then tends to pass towards directors.

Other countries offer other models. State control persists in China, Japanese companies commonly have cross-holdings with many other companies, while in Russia and other post-Soviet bloc states, privatisation of state-run companies has led to the concentration of assets in the hands of relatively few powerful shareholders.

Another factor affecting the balance between shareholders and directors is the extent to which different jurisdictions provide the tools for shareholders to engage with and influence companies. Our research has revealed wide variations in the rules that govern relations between company and shareholders in different countries. These affect issues ranging from typical proportions of independent board members to the proportions of investors needed to support an item in order to table it at the annual general meeting.

Table 2: Examples of variations in the legal basis of shareholders' rights in selected countries [14]

	U.S.	Japan	Germany	UK	France
Threshold for sale of assets requiring approval of general meeting	Substantial part; can be as low as 50%	Substantial part; can be as little as 10%	ca. 80%	25%	No threshold
Threshold for ability to put item on general meeting agenda (expressed as % of capital held)	Any shareholder if bears costs; otherwise 1%	1%	5%	5%	<1%
Shareholder decision making by post or by proxy	Legally required, including solicitation rights	Legally required, including solicitation rights	Companies to assist in the use of proxies.	Can be constrained by company	Legally required, including solicitation rights
Multiple voting rights	Available	Prohibited	Prohibited since 2003.	No stipulation	Double voting right if held for more than 2 years
Independent board members	More than half	No stipulation	More than 1 in 8 (on average)	More than half	More than 1 in 8 (on average)
Feasibility of director's dismissal	Not always compensated, but fixed term contract possible	Always compensated for dismissal without good reason	Always compensated for dismissal without good reason	Only contractually agreed compensation	Only contractually agreed compensation
Derivative suits to privately enforce directors' duties	Min 1% share capital held	Min 5% share capital held	Min 1% share capital held	Min 5% share capital held	Readily possible
Shareholder action against resolutions of general meeting	Every shareholder can file	Every shareholder can file	Every shareholder can file	Every shareholder can file	Every shareholder can file
Threshold for mandatory bid	No stipulation	One-third, but offer does not have to be for all outstanding shares	30%	30%	One third of shares
Disclosure of major share ownership	More than 5%	More than 5%	More than 5%	More than 3%	More than 5%

Italy	Canada	China	India	Brazil	Mexico
No threshold	"All or substantially all", but can be as low as one-third	80%	"Whole, or substantially the whole" of an undertaking	No threshold	Directors can buy or sell assets with value of 5% or more
10%	Any shareholder	5%	20%	5%	Not directly able; need to raise issues with commissaries monitoring the company
Postal and proxy voting allowed	Can be constrained by company	Proxy voting, but not postal voting possible, but can be constrained by company	Postal ballot legally required for major resolutions	Personal attendance by shareholder or proxy required by law.	Can be constrained by company
Prohibited	Possible	Prohibited	Prohibited	Prohibited	Prohibited
More than 1 in 5 (on average)	More than half	More than 1 in 3 (on average)	More than 3 in 8 (on average)	More than 25%	More than 25%
Always compensated for dismissal without good reason	Not always compensated, but non-fixed term contract possible	Always compensated for dismissal without good reason	Not always compensated, but non-fixed term contract possible	Not always compensated, but non-fixed term contract possible	Not always compensated, but non-fixed term contract possible
Min 5% share capital held	Readily possible	Min 5% share capital held	Min 5% share capital held	Min 5% share capital held	Min 5% share capital held
Every shareholder can file	Every shareholder can file	Every shareholder can file	Normally min. 10% voting rights threshold.	Min 10% voting rights threshold	Min 20% threshold
30%	20%, but offer does not have to be for all outstanding shares	30%	15%, but offer does not have to be for all outstanding shares	Related to "acquisition of control", instead of a specific percentage	30%
More than 2%	More than 10%	More than 5%	More than 5%	More than 5%	More than 10%

In summary

So, to summarise our observations on the nature of ownership:

- Companies cannot be 'owned' in a technical sense – they are separate legal entities.
- 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 directors of companies are the effective controllers of companies – they are entrusted by shareholders with the management of the company on a day-to-day basis.
- However, directors are accountable to – and can be influenced in varying degrees by – their shareholders, through engagement and dialogue or indirectly through shareholders' sentiment reflected in the share price.
- Shareholders have roles as members, scrutineers, financiers and stewards.
- We believe that shareholders or their agents should exercise their stewardship role and engage with the directors of companies to help them in their own exercise of stewardship. This protects the long-term health of the company and promotes the long-term value of the investment.

Colin Melvin, Director of Corporate Governance of Hermes and Chief Executive of Hermes Equity Ownership Services Limited (EOS), explains this relationship in describing the work that EOS do:

> *"The work I do is to some extent addressed at taking the intermediaries out of the system, addressing some of these problems and getting a proper conversation going, a dialogue between the owners of the companies, the pension funds, and the companies themselves. We don't manage money for these funds. We don't buy and sell the shares. That's done by other fund managers. What we do is represent them in engagements and discussions with companies, we vote the stock and we have a long-term conversation with companies about longer term strategy and value creation. And it's not about giving companies a hard time, it's not about second guessing or micromanaging them, I wouldn't pretend to know how to manage some of the largest companies we engage with. It's about calling to account some of the directors for their performance on behalf of the owners. And that process we very firmly believe adds value for the long-term owner and the pension fund."*

Part 4: The changing ownership landscape

Changes in ownership patterns are taking place in a complex landscape that includes many types of company and many classes of shareholders.

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Changes in ownership patterns are taking place in a complex landscape that includes many types of company and many classes of shareholders.

Today's interest in ownership arises largely because several specific classes of investors, chiefly hedge funds, private equity (PE) and sovereign wealth funds (SWF), have increased in influence over the past decade and this has provoked reactions from those who previously held more sway, including states, families and institutional investors.

Ira Millstein, Associate Dean for Corporate Governance at the Yale School of Management, when discussing why corporate governance has reached international concern, said:

> *"The main reason is the advent of the capital market explosion of organizations such as hedge funds, private equity funds, state-owned enterprises, sovereign wealth funds, pension and mutual funds of all varieties, and combinations of them all. This array has created for corporations and their boards a "zoo" of owners with different stripes, teeth, sensors, claws, vision, strength, will, and attitudes. All of these must be taken into account by boards, who have always been cautioned to be "fair" to all shareholders. Compounding the situation is the creation of a blizzard of financial instruments. Professors Goetzmann and Rouwenhorst noted in their treatise on the "Origins of Value" that "instruments spring from the mind of investment bankers almost overnight, and then are analyzed, valued, traded, saved, and hedged themselves – sometimes to be replaced by new financial instruments…"*

Comparing this with the 1980s he said:

> *"The then commonality of interests and purpose between institutional shareholders and the corporate enterprise was the premise on which boards and shareholders built the developing governance paradigm. But this premise of commonality seems to be eroding in the current capital markets landscape."* [15]

Companies, too, come in many forms. They can be publicly quoted, partly or fully owned by families or individuals, state-owned, employee-owned – including co-operatives – or owned by trusts or foundations.

In this section, we examine some of the major trends affecting ownership before going on to look in detail at different types of companies and investors.

The data in this section comes from the G7 countries (United States, Japan, Germany, UK, France, Italy and Canada) and, where possible, a selection of developing countries – China, India, Brazil, Russia, Indonesia, Mexico and Turkey, referred to as the E7.[16]

Types of company

The listed company model

Much of the analysis and discussion about the ownership of companies relates to public companies; i.e. those listed on stock exchanges. However, as noted in the previous chapter, this model does not dominate worldwide. This can be seen by looking at the ratio of the total market capitalisation for all companies domiciled in a country with the GDP of that country – a measure used to show the importance of the listed sector in any given economy.

Table 3 compares the market capitalisation of domestic listed companies with the GDP of our chosen countries at the end of 2006.

Table 3
Market Capitalisation and Gross Domestic Product 2006[17]

Country	Market Capitalisation (U.S.$bn)[a]	GDP (current prices) (U.S.$bn)[b]	Market capitalisation/ GDP
United States	19425.9	13192.3	147%
Japan	4726.3	4435.0	107%
United Kingdom	3794.3	2372.5	160%
France	2428.6	2234.4	109%
Germany	1637.8	2888.7	57%
Canada	1700.7	1270.6	134%
Italy	1026.6	1848.0	56%
China	4141.3[c]	2666.8	155%
India[d]	818.9	903.2	91%
Russia	1057.2	984.9	107%
Brazil	711.1	1067.8	67%
Mexico	348.3	829.6	42%
Indonesia	138.9	364.5	38%
Turkey	162.4	392.3	41%

Refer to source note for explanation of annotations within the table.

If we examine how this ratio has shifted over the last two decades, we can see why it is a myth to believe that the large listed company with widely dispersed shareholders is a dominant model which will ultimately drive out others. Over time the balance between listed companies, private companies and state-owned enterprises has fluctuated, favouring one model then another.

Chart 1 shows how the ratio of total market capitalisation for all companies domiciled in the G7 and E7 countries relative to their GDP has changed over the period from 1990 to 2006.[18] While there has been a general increase in the importance of the listed sector over recent years, this has been interrupted during periods of economic difficulty, such as Japan's stagnation in the 1990s and the currency crises in Mexico and Asia in the later part of that decade. The reaction to the irrational exuberance of the 'dot-com bubble' at the turn of the century can be seen in the subsequent drop in the ratio for the United States, Germany, the United Kingdom and Italy.

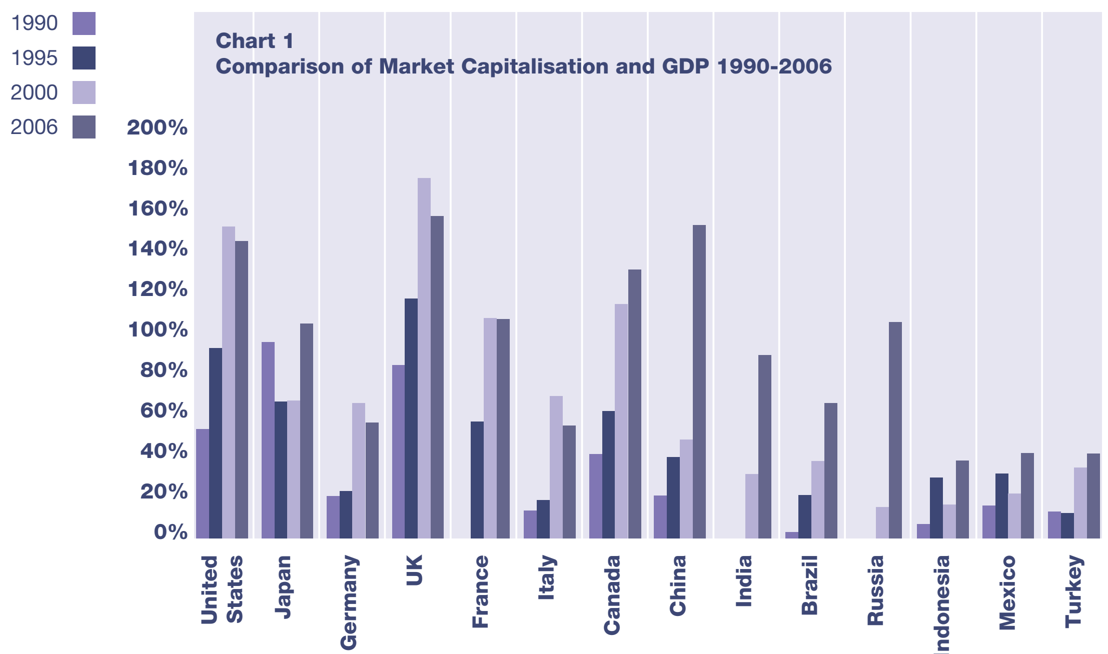
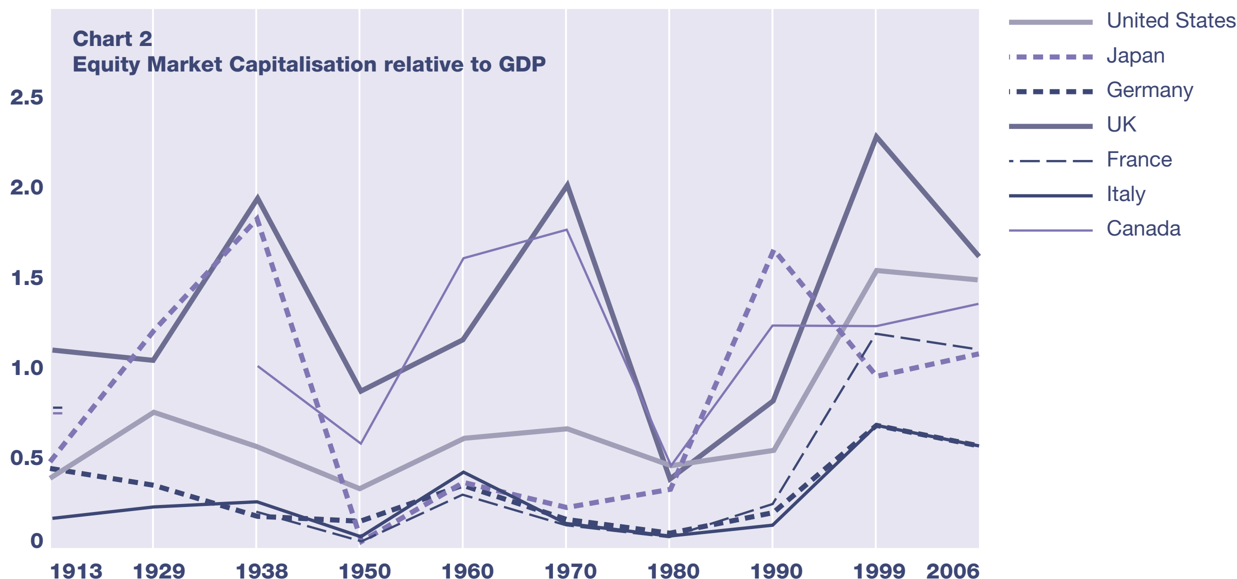


Chart 1
Comparison of Market Capitalisation and GDP 1990-2006

Changes in the ratio can be attributed to many factors including:

- changes in the performance of the economy as a whole;
- programmes of privatisation and listing of state-owned enterprises;
- the attractiveness of a country as a domicile;
- the attractiveness of a country to an investor, from factors such as market liquidity, governance practices and the risk of expropriation;
- changes in disposable income seeking a return;
- the validity of the forecasts and judgements used to ascribe values to companies; and
- the attractiveness of investing directly in company shares as opposed to bonds, property, derivatives or other investments.

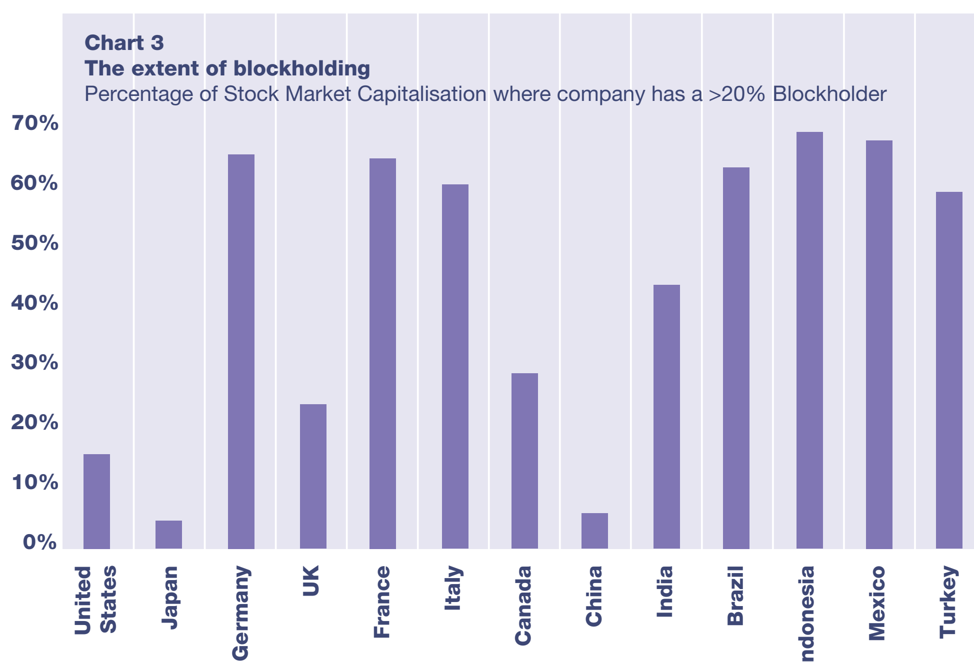
Taking an even longer perspective, that of the past century, we see even more sharply how the significance of listed companies has ebbed and flowed. See Chart 2.[19]



Each of the G7 countries has seen two periods in the last 90 years when market capitalisation fell back significantly. The first stemmed from the impact and aftermath of World War II, including programmes of reconstruction and nationalisation, seen in the fall between 1938 and 1950. The second period of relative weakness was during the 1970s, when economies were exposed to two oil price shocks.

As previously mentioned, structures vary significantly around the world. In some countries, notably the United States and United Kingdom, a public company's shares are typically dispersed across a large number of shareholders. However, this type of structure is not the norm. In most of the countries examined, it is common for there to be one or more shareholders on the register who hold, directly or indirectly, a block of shares with 20% or more of the voting rights.[20]

Chart 3 shows the extent of blockholding in our selected countries.[21]



Blockholding affects around 60% of the total market capitalisation in France, Germany and Italy, as well as many of the emerging economies. The results for China and Japan appear counterintuitive and are a reminder that factors other than share ownership are important. The simple 20% holding test does not capture the structural arrangements that exist in these countries. Crossholdings among *keiretsu* partners in Japan rarely reach the 20% level, yet together they can be highly influential. In China private property rights are being developed and corporate control is exercised more through political means.

The unlisted company model

Listed companies are only a part of the economic landscape. Worldwide, most companies are unlisted and these companies make up the majority of the economy in most countries. They are diverse, encompassing family businesses, employee-owned, co-operatives and mutuals, those owned by trusts or foundations and private equity.[22]

Private small and medium-sized enterprises (SMEs) play a key role in transitional and developing countries. These firms typically account for more than 90% of all firms outside the agricultural sector.[23] In countries such as Italy and India, and to a degree France, the economy has evolved around large private companies controlled by an individual or family. SMEs are responsible for between 60-70% net job creation in OECD countries.[24]

Of the top 100 unlisted companies in the UK in 2007, 39 had private equity investment, 32 had significant ownership by a founding entrepreneur and 21 were family-owned. 17 of the companies had previously been listed, while three were subsidiaries or divisions of listed companies.[25]

In the United States alone, 424 unlisted companies have revenues of over $1 billion – a level achieved by around 1850 listed companies across the world.[26] There are also approximately 6000 companies in the U.S. where employees own 30% or more of the company's shares,[27] while in the UK employee-owned companies are worth around £25 billion and one, the John Lewis Partnership, features in the top 100 UK unlisted companies.[28]

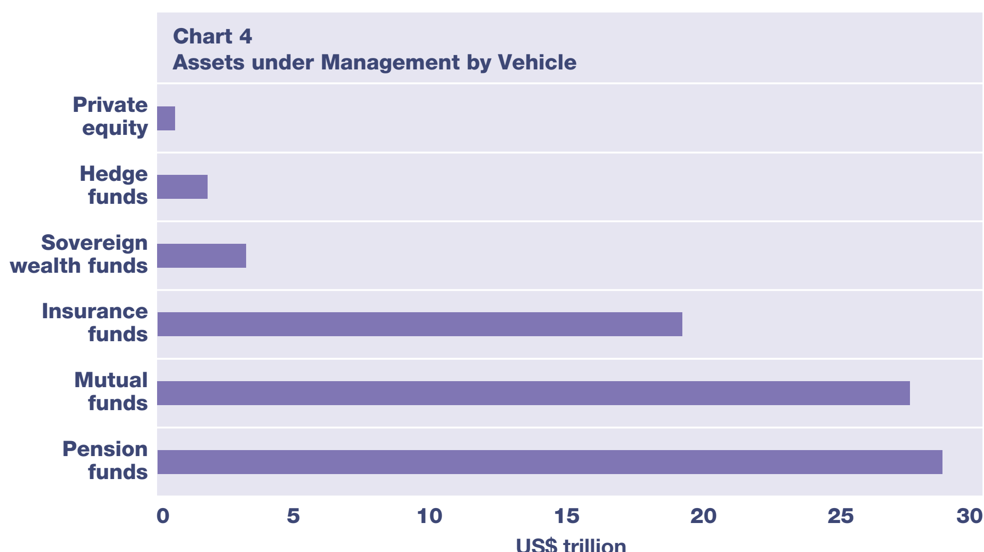
These different forms of companies are discussed in more detail in Part 5.

Types of shareholders

Shareholders are heterogeneous, both in form and investment objectives, and can be classified as private, public or state.

- Private shareholders, such as individuals and insurance houses, are principals who invest on their own account. They can in principle establish their investment criteria and objectives without reference to others. These shareholders can be private about their dealings;
- Public vehicles, such as pension funds or mutual funds are agents which invest others' money and have obligations within which they have to operate, such as meeting a fiduciary duty or the terms on which the fund is marketed. These shareholders need to be public in accounting for their performance, at least to their clients;
- State funds can be shareholders for purely financial purposes or to meet other state policy objectives.

Chart 4 shows the relative size of the assets under management for different types of investors, including SWFs, hedge funds and private equity, as well as the pension, mutual and insurance funds that are viewed as the more traditional owners.



At the end of 2007, SWFs were thought to have U.S.$3.3 trillion under management. By comparison, hedge funds are thought to be managing assets worth U.S.$2.3 trillion and private equity U.S.$0.8 trillion of assets.[29]

Although there has been intense debate recently over the newer classes of investors, traditional forms of investment through institutional investors are of an order of magnitude greater than these alternative approaches. The world's pension funds, mutual funds and insurance funds have around 10 times as much money under management as hedge funds, SWFs and PE together – at least for the moment.

However, patterns of ownership are dynamic, as can be seen from the way that the mix of shareholders has changed in the past 50 years in listed companies in the developed world. Here we focus on the UK and Germany, but broadly similar patterns have been seen in other countries. (See Tables 4 and 5).

Table 4
Beneficial ownership of UK shares (as % of total equity owned) 1963 – 2006 [30]

	1963	1969	1975	1981	1989	1993	1997	2000	2003	2006
Rest of the world	7.0	6.6	5.6	3.6	12.8	16.3	24.0	32.4	32.3	40.0
Insurance companies	10.0	12.2	15.9	20.5	18.6	20.0	23.5	21.0	17.3	14.7
Pension funds	6.4	9.0	16.8	26.7	30.6	31.7	22.1	17.7	16.0	12.7
Individuals	54.0	47.4	37.5	28.2	20.6	17.7	16.5	16.0	14.9	12.8
Unit trusts	1.3	2.9	4.1	3.6	5.9	6.6	6.7	1.7	2.0	1.6
Investment trusts	11.5	10.1	10.5	6.8	1.6	2.5	1.9	2.1	2.3	2.4
Other financial institutions					1.1	0.6	2.0	4.6	11.1	9.6
Charities, churches etc	2.1	2.1	2.3	2.2	2.3	1.6	1.9	1.4	1.2	0.9
Private non-financial companies	5.1	5.4	3.0	5.1	3.8	1.5	1.2	1.5	0.7	1.8
Public sector	1.5	2.6	3.6	3.0	2.0	1.3	0.1	0.0	0.1	0.1
Banks	1.3	1.7	0.7	0.3	0.7	0.6	0.1	1.4	2.2	3.4
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Table 5
Beneficial ownership of German shares (as % of total equity owned) 1960 – 1998 [31]

	1960	1965	1970	1975	1980	1985	1990	1995	1998
Foreign	5.6	8.9	8.5	9.9	11.1	14.4	12.9	10.3	15.6
Insurance companies	3.4	3.7	4.2	4.2	4.8	5.8	9.8	10.9	13.7
Investment funds	NA	NA	NA	NA	NA	NA	4.3	7.5	12.9
Private holdings (includes individuals)	30.3	30.6	31.3	25.1	21.2	22.5	17.2	15.3	15.0
Non-financial companies	40.7	39.3	37.4	42.1	42.8	38.8	41.7	41.5	30.5
Public sector	12.0	10.0	9.5	8.9	8.5	7.5	3.7	4.4	1.9
Banks	8.0	7.5	9.1	9.7	11.7	11.0	10.3	10.1	10.3
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Two major trends are clear – first a shift from individual shareholders to institutions in the latter half of the 20th century; and second the growth of foreign shareholders over the past two decades.

The decline in the holdings of domestic institutional investors is partly the corollary of the increase in foreign holdings.

Shift from individual shareholders to institutions

Individuals held over a half of UK shares in 1963. Today they hold around an eighth. Domestic institutions such as pension funds and insurance companies – who had held only one sixth of the shares in 1963 – held over a half at the high point of their dominance around 1993, but today their share has slipped back to around a quarter.

'Other financial institutions', which include hedge funds and dealers investing on their own account, have also taken a much larger share of the market in recent years.

Individuals still have some link to company ownership because they take part in collective investment vehicles, such as pension schemes and mutual funds, which have made many people in developed countries the beneficiaries of the success of listed companies. However, for many people that is the limit of their engagement, as the operation of many of these vehicles has not facilitated the involvement of the ultimate beneficiary.

In his recent book, *The New Capitalists*, David Pitt-Watson argues that since in the UK more than 75% of shares in the UK stock market are held through collective investment vehicles, it is actually the workers or citizens who own the means of production.[32] Based on this premise, at the time of writing, David Pitt-Watson is working with the RSA in a programme called *Tomorrow's Investor*.

The *Tomorrow's Investor* programme is asking three questions.

1. How can the two thirds of citizens who ultimately own these shares exercise some degree of control over them?
2. What are citizens actually looking for from their investments – what choices might they make, what trade-offs might they prefer, what would their reaction be to some of the dilemmas faced by the companies they own?
3. Is there the possibility of creating new kinds of funds which could represent a citizen investment and better reflect citizen priorities than the current marketplace?

The RSA and Tomorrow's Company will be exchanging the outputs of their respective projects as they develop.

Growth of foreign shareholders

Whereas at one time the ownership of the share capital of a company was typically restricted to institutions or citizens of the country in which the company was located, increasingly shares are held by global investors.

In the UK, foreign investors held less than a sixth of the shares in 1993, but today they hold at least 40%. In fact by 2007, the UK Treasury was reporting that foreign ownership of the UK quoted corporate sector had reached around 50%.[33]

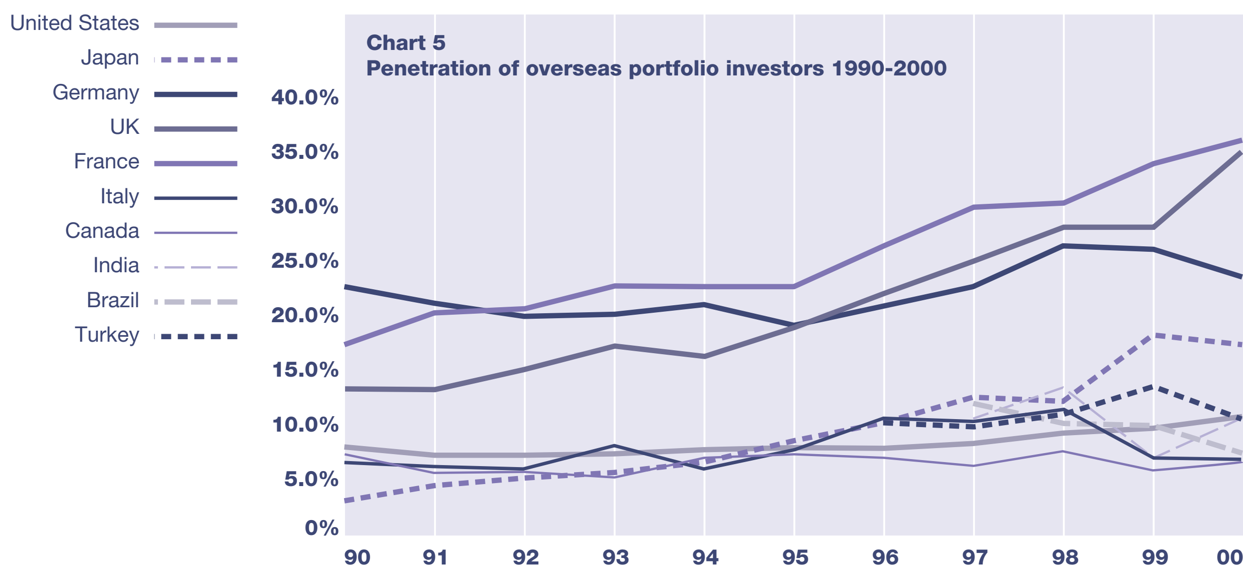
The growth of foreign shareholders in many markets results from the increasing ease with which capital can flow across borders. This is becoming a more significant factor in shifting ownership patterns than national influences such as legal systems, local cultural perspectives and the particular stage of economic growth prevailing in a given country.

Foreign investment comes in several forms – takeovers and mergers; the purchase of stakes in companies; the development of local plant or operations and the establishment of subsidiaries.

There is an expanding network of international investment agreements to facilitate foreign direct investment (FDI) and transnational or multinational companies play a major role in ownership shifts through cross-border mergers and acquisitions. Estimates for 2006 suggest there were just under 7,000 cross-border mergers or acquisitions[34] and that 78,411 parent companies were operating internationally through 777,647 affiliates.[35]

Foreign investors include pension, mutual and insurance funds, sovereign wealth funds, foreign domiciled private equity houses and hedge funds.

Chart 5 illustrates how this trend has been experienced in several markets around the world.[36]



The rise of 'East-buys-West' deals

A particular aspect of the growth of cross-border ownership has been the recent rise in acquisitions of companies in developed countries by those from emerging countries – particularly Asian companies taking over western ones. This trend may be being accelerated by the asymmetry of the credit crunch, which appears to be affecting OECD markets more than Asian ones. KPMG's Emerging Markets International Acquisition Tracker, which records cross-border takeovers between 10 selected emerging economies and 11 key developed markets reported that in the second half of 2007, 62 deals saw emerging market companies buying into the developed markets, while 105 deals went in the opposite direction. Emerging-into-developed deals now equate to 59 percent of the developed-into-emerging total; the closest the two totals have ever been. If the trend continues, then a crossover point is approaching.[37]

Indian companies are proving particularly resilient in the face of the credit crunch, with 35 deals between India and the developed economies in the second half of 2007. The acquisition of Arcelor by Mittal Steel (a company of Indian origin, although head-quartered in the Netherlands) for $32 billion was the world's largest cross-border M&A transaction in 2006.[38] Other major Indian acquisitions have included: India's largest aluminum producer, Hindalco Industries Ltd., buying U.S.-Canadian rival Novelis and Tata Group paying $8.1 billion for Corus Group Plc, the Anglo-Dutch steelmaker.

By contrast, takeovers of emerging market businesses by U.S. companies are slowing. The second half of 2007 saw the number of U.S.-backed deals into the emerging economies collapse from 67 to 39.[39]

The threat of protectionism

Globalisation of ownership has led to debate in some countries over whether foreign-based organisations should be allowed to buy certain national assets, along with calls for measures to prevent such takeovers.

In the U.S., the debate was triggered by the attempt of Dubai Ports to take over P&O. Acquisitions of American firms by overseas state-owned companies now face tougher scrutiny following the passage of a new law which requires the committee on overseas investment to conduct a 90-day investigation of takeovers by government-owned companies unless the U.S. Treasury secretary determines they would not impair U.S. national security.

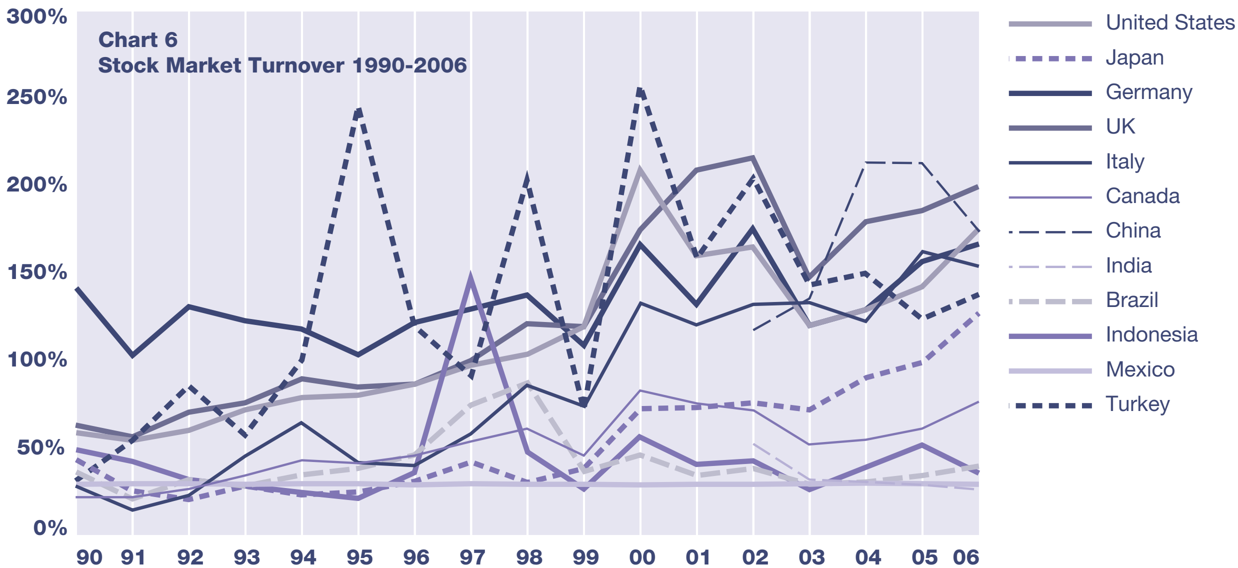
In July 2008, the Federal Financial Markets Service of the Russian Federation (the *"FFMS"*) introduced new thresholds for securities that Russian companies can place overseas including specific limits in respect of shares in "strategic" companies – no more than 30 per cent of the capital of a Russian company may be placed outside Russia. More importantly, the new Order introduces even lower thresholds for "strategic" companies.[40]

Some individual companies have their own bars on foreign ownership. The articles of association of Rolls-Royce, for example, include a limit of 15% on individual foreign shareholdings.

Shorter shareholding periods

As well as these changes in the nature of shareowners, there has also been a trend in most stock markets towards shorter average holding periods.

Chart 6 shows this increase in terms of stock market turnover, the ratio of the value of shares traded during a year to the total market capitalisation at the end of the year.[41]



Increasing stock turnover means that shares are being held for shorter periods and this could imply a growth in a trader mentality among shareholders and a reduced sense of shareholders being involved in companies as owners. However, the same outcome may result from some shareholders continuing to act as long-term investors in companies, while others churn shares at faster and faster rates in pursuit of short-term returns. The pattern is also affected by the fact that significant proportions of shares are held in index tracker funds which means that portfolios are frequently adjusted. However, many investment funds retain some holding in the companies they invest in, although they adjust the holding to adopt underweight or overweight positions within the portfolio. So while stock holding periods are getting shorter on average, the causes are complex and the behaviour that leads to increasing stock turnover is an area that warrants further investigation.

Part 5: The array of investors

To what degree does each type of investor fulfil their stewardship role?

One of the most significant trends of the past few years has been the rapid rise of private equity (PE) investment.

One of the reasons for producing this report has been the rise to prominence of particular classes of investor over the past decade – primarily PE, hedge funds and SWFs – and changes in behaviour among traditional institutional investors. In this section we examine each key player/investor, examining some of the salient facts, reviewing what has been said about them and assessing the degree to which they act as stewards of the companies they invest in by seeking to influence them in the direction of long-term, sustainable, performance.

Private equity

Background

One of the most significant trends of the past few years has been the rapid rise of private equity (PE) investment.

According to Private Equity Europe:

> *"This year (2008) has been the most high profile in the history of private equity."* [42]

'Private equity' means different things to different people. It is sometimes broadly defined to include venture capital funds, growth capital funds and buyout funds. The first two categories invest in companies which they see as promising future performers to enable them to start up, grow and expand. The latter invest in companies they see as underperformers in order to 'turn them round' and either return them to the listed sector or manage them for growth. Buyout PE is the category that has been in the spotlight in recent years. Having said this, many financial players invest in all of these ways, with a common factor being close involvement with the owned company. There are also a limited number of private equity and venture capital investment companies, such as 3i, whose shares are listed on a stock exchange.

High profile companies bought by PE have included Boots and EMI in the UK, and Danish telecoms operator TDC. Private buyout activity has become an increasingly important feature of the U.S. economy, growing from $24.6 billion of activity in 2000 to $356.7 billion during the first 11 months of 2007, according to Thomson Corporation.[43] Huge deals have included the buyout of Texas energy giant TXU by Kohlberg Kravis Roberts & Co. and its partner Texas Pacific Group for $44.3 billion.

Some believe the advance of private equity may be slowed by a less expansive lending climate. Others believe that while mega-deals such as the TXU takeover may halt for a while, private investors will continue to seek out companies that they believe are either undervalued by the market or that present unique opportunities, a typical example being the $7.4 billion acquisition of a majority stake in Chrysler Group by Cerberus Capital Management.

While developed markets undergo a slowdown, private equity is finding new opportunities in emerging markets. For example, private equity company 3i believes Asia has potential to become its largest region for investment, overtaking continental Europe.[44]

Institutional investors are often attracted to private equity investments as part of a broad asset allocation and in the hopes of achieving risk adjusted returns that exceed those possible through the stock market.

Perceptions and responses

The private equity industry has been criticised for its apparent profiteering and asset stripping. However, according to Sir Ronald Cohen, co-founder of Apax Partners, this view *"doesn't really resonate with the industry."* Sir Ronald says that far from being a negative influence, private equity has been, *"an agent for change in the British economy"* indeed its impact has been, *"nothing short of miraculous."* [45]

However, the growth of private equity has led to calls for more transparency from private equity firms. In the UK, the British Venture Capital Association responded by commissioning a report from Sir David Walker, *Guidelines for Disclosure and Transparency in Private Equity*, published in 2007. It recommended, amongst other things, that private equity companies involved in buyouts of large companies publish balance sheets with details of debt and narratives by their chairman or chief executive, covering the company's approach to staff and its role in the community. The Guidelines Monitoring Group is an independent body that was set up as a direct result of the review. To date, 32 firms have signed up to the Guidelines.[46]

The International Union of Food and Agricultural Workers (IUF) has set up a Private Equity Buy Out Watch on its website in an effort to prompt private equity firms to disclose more about their CSR approach.[47] The UNI Global Union (Union Network International) has also turned its attention to what it sees as the risk of private equity buyouts edging out strategic, industry-based investors. Its concern is that this may increase the risk of failure among newly formed companies, with the inevitable fallout for jobs and pensions. Others are concerned about the amount of debt that is loaded onto bought-out companies.[48] In the U.S. a number of leading private equity firms announced the formation of a Private Equity Council to increase understanding of private equity.

Role as 'steward'

In a sense, PE is potentially the ultimate in shareholder stewardship. Buyout PE firms do not simply seek to influence companies through engagement. They buy them – or at least buy large stakes in them – in order to exercise direct control and turn them round. They were described to us by one business leader as *"the shareholder in the boardroom – a positive force."* Sir Anthony Cleaver, who has chaired a range of companies and organisations including IBM UK Ltd and the UK's Engineering and Technology Board, said when interviewed:

> *"I think there are many people out there who take the view that private equity are asset strippers and vandals. However I've now chaired four companies that have been mainly owned by private equity investors – and I have found them to be the best owners I've dealt with."*[49]

In a sense, PE is potentially the ultimate in shareholder stewardship.

A recent study by Cass Business School showed that the average length for which a buyout PE firm invests in a company it has bought is nearly four years.[50] A further study in 2008, undertaken for the World Economic Forum, found that 58% of the private equity funds' investments are exited more than five years after the initial transaction.[51]

Some PE firms, such as Permira and Apax Partners, are opting to keep their acquisitions and manage them for longer term growth, developing conglomerate style stables of companies, rather than returning them to the listed market. Sir Anthony Cleaver praised his PE investors for sticking with one of the technology companies he has been involved in through the 'dot-com' crash, accepting the disappointment of an abandoned IPO, advising directors on how to survive and recover and eventually seeing a successful listing take place several years later.

Defenders of PE say it tends to restore the links between ownership, financing, control and stewardship of a company. They also say that PE ownership frees companies from the short-term pressure to report ever increasing profits. However this has to be balanced with a recognition that in many cases the PE investor's priority is a profitable exit within around five years, as opposed to the establishment of roots from which will grow a great company that may last many generations.

Knut Norheim Kjær, former CEO of Norge Bank Investment Management, noted that:

> *"The best of PE creates genuine alpha value by improving the performance of companies. But PE often works through financial engineering and releases value without strengthening the company's fundamentals. In general PE has positive effects on corporate governance in the public market. It strengthens the market for corporate control and thus improves the alignment between managers and owners. However, we do see cases where a company is bought out at a low price, with huge rewards to its management, due to lack of checks and balances and weak representation of ownership interests by the board. The answer is not less PE but more active ownership and better corporate governance of the public market."*

Others have pointed out that while PE firms may be loyal to the companies they buy and act in their best interests, they may not have such a strong sense of loyalty to other stakeholders, such as the wider community. One interviewee, with a long experience in corporate governance, commented that:

> *"There is a disconnect between the private equity model and the role of business in society. It is important to ask investors what view they have on the role of business in society. If a company is under pressure in a particular jurisdiction it is going to be asked what it is going to do to cut its costs on its social expenditure?"*

Many PE firms do take their responsibility to the wider community very seriously, for example, Terra Firma. Since being set up by Guy Hands in 1994, it has invested approximately €11 billion of equity and completed transactions with an aggregate enterprise value of €42 billion. It states:

> *"We recognise that the businesses we invest in touch the lives of many people and we are mindful of the social responsibilities that our investments bring. We are aware, too, that private equity and its role in the business community are frequently misunderstood. We believe passionately that Terra Firma, and the private equity industry in general, have much to be proud of with our record in restructuring companies and helping businesses to grow. We ensure that we are open about our approach and our business and we welcome interaction with our stakeholders."* [52]

'Hedge funds'

Background

'Hedge funds' have become hugely controversial – despite the fact that there is no common definition of what they are.

'Hedge funds' have become hugely controversial – despite the fact that there is no common definition of what they are. Their name derives from the practice of using one investment as a 'hedge' against another – for example, hedging investments in shares expected to rise in value by shorting stocks seen as likely to fall.

The term has now expanded to describe a variety of 'alternative investment' funds that invest in order to generate high absolute returns, as opposed to seeking to outperform market benchmarks.[53] Hedge funds cannot generally seek funds from the public. Accordingly they are not exposed to the breadth of regulation affecting larger investors, such as pension funds, which look after the savings of millions.[54] However, institutional investors – so ultimately retail investors – are increasingly channelling money into hedge funds through 'fund-of-funds' vehicles which invest in a range of hedge funds.

Hedge fund investment approaches vary from 'quantitative' approaches in which software picks up trends and trades stocks automatically to 'fundamental' techniques that involve in-depth scrutiny of companies' valuations. Some specialize in long-short combinations. 'Global macro' funds assess which stocks will move as a result of global economic developments – George Soros being a notable example – while 'event-driven' funds take positions in companies affected by 'special situations' such as mergers, takeovers or involvement in major news stories.[55]

Assets under management in the global hedge fund industry are estimated to have increased from $710 billion in 2002 to a record $2,250 billion at the end of 2007, according to the International Financial Services, London's (IFSL) *Hedge Funds* report.[56] Hedge funds are believed to account for approximately 35% of U.S. activity in investment-grade derivatives and 30% of equity trades.[57] There were more than 1,500 European-based hedge funds in 2007, of which two-thirds were located in London.[58]

Perceptions and responses

One frequently cited allegation is that hedge funds have little interest in the long-term fortunes of the companies in whom they invest, but are simply looking for movements in price. Company chairmen and executives have their own stories to support this claim.

> *"It may be old-fashioned but I view a shareholder as a shareholder – someone whose interests in the success and prospects of the company lasts more than three weeks… I have real concerns about promoting the use of my company's stock as hedge fund plays – just as I would if they were chips in a casino."* John Sunderland (former President of the CBI, the employers' body, and former Chairman of Cadbury Schweppes plc).[59]

One listed company CEO describes being mystified as to why his company's shares have hit record highs and lows over a period of relatively steady growth. He also said he could not identify the shareholders who might be driving this activity.

The active role taken by hedge funds in financial markets means that they attract both praise and criticism in strong measure.

There is particular controversy as we write over the activities of short sellers who profit by borrowing stock – usually from a large institutional investor or bank – selling it, buying it back at a lower price and returning it to the lender, while keeping the profit. It has been estimated that there is about $4.5 to $5 trillion of stock available to short in the world (about 10% of the world's lendable stock and 3% of the world's total equity supply).[60]

Some suggest that such behaviour is destructive; it is naturally disliked by targeted companies. Others argue that if a stock is overvalued it is in the company and market's interest – both for transparency and the company's long-term interests – to expose the overvaluation. The UK Financial Services Authority (FSA) has introduced in June 2008 a requirement for next day disclosure of large short positions in companies undertaking rights issues.[61] The FSA has said: *"The FSA views short selling as a legitimate technique which assists liquidity and is not itself abusive,"* but goes on to say *"improving transparency of significant short selling in such shares would be a good means of preventing the potential for abuse."* In these circumstances non-disclosure of significant short positions gives the market a false and misleading impression of supply and demand in the securities concerned.

An associated controversy is the use of derivatives to take large stakes in companies through using contracts for difference (CfDs) without the market being aware who the true moving force behind the purchase is. In the UK, the Financial Services Authority has ruled that investors must reveal long CfD positions if they – along with other holdings – exceed 3% of companies' value.[62]

The active role taken by hedge funds in financial markets means that they attract both praise and criticism in strong measure.

> *"Hedge funds is such a loose term. Hedge funds represent the best investors, the ones who give companies the most challenging meetings, the most interesting idea. On the other hand the quant funds are just noise. Then there are those activists who just come in to make mischief."* Simon Nixon, business journalist.

In response to the charges against hedge funds, VS Vasudevan, President, European Operations, Dr Reddy's Laboratories, and formerly Group Finance Director, commented:

> *"I am not worried. In simple terms there are two sets of players. One set comprises individuals who save and the second set are people or agencies that help such individuals put their savings to use. In between it is all arbitrage. The domination of hedge funds in the capital market is temporary as such funds will mature into regular investment funds as they grow bigger and successful. Success will lead to maturity."*

Concerns about hedge fund activities have prompted calls for regulation in several regions.

In the U.S., where a 2006 rule change by the Securities and Exchange Commission requiring hedge fund advisers to register under the Investment Advisers Act was overturned by the U.S. Court of Appeals, the President's Working Group on Financial Markets has rejected further regulation preferring to set out "best practice" guidelines.[63]

The European Parliament is considering whether there is a need for an increase in regulation of Hedge Funds.[64]

In a more liberalising move, the FSA is also finalising rules that will allow Funds of Alternative Investment Funds (FAIFs) to be introduced in the UK – giving retail investors access to hedge fund investments.[65] Meanwhile, some leading UK hedge funds, responding to a call from Sir Andrew Large, the former deputy governor of the Bank of England, have published best practice standards for hedge fund managers.[66]

Role as 'steward'

It is easy to dismiss hedge funds as gamblers rather than stewards but this is not the whole picture.

Hedge funds often come in for criticism on the grounds that they militate against good stewardship by focusing on short-term shareholdings and short-term shifts in share price. One company chairman told us that when a hedge fund, which was suggesting his company's stock was overvalued, refused to share its research and admitted it was an 'event-driven' fund of the kind which focuses on takeover bids, he felt it hard to have the same duty of care towards it as an owner that he had towards the long only institutional shareholders. However, many business leaders also paid tribute to hedge funds for the rigour of their research. One chairman told us they usually knew more than the institutional investors, albeit that the rationale for such in-depth work is often to demonstrate to the market that the stock is over valued.

It is easy to dismiss hedge funds as gamblers rather than stewards but this is not the whole picture. Where they expose deficiencies or highlight benefits of companies that others have not spotted, they can be fairly said to be positive for the market and the economy as a whole in their role as 'scrutineer'. As institutions, such as pension funds, endowments, foundations and even central banks have diversified their portfolio to include hedge funds; this has had a beneficial effect. The professional managers of these institutions are typically more demanding than individual investors in requiring better investment processes and, for example, enhanced reporting on a more frequent basis.

Research by a group of U.S. experts collected together data based on 888 events launched by 131 activist hedge funds during the period 2001 to 2005 and in so doing, have brought an empirical basis to the analysis of hedge funds which has been lacking up to now. They conclude that the evidence they have gathered indicates that, contrary to the received wisdom, hedge fund activism not only generates substantial positive abnormal returns, but it also generates long-term benefits for shareholders.[67]

There are a few explicitly 'socially responsible' hedge funds – such as Green Cay Asset Management with around $200 million under management – which are managed using both social and environmental factors. Such funds can provide investors with high returns, particularly in negative market environments. For example, they short sell companies with poor environmental, social or ethical records as a way of sending clear messages to companies to improve their social and environmental performance. This may sound diametrically opposite to SRI but they expose the problems at the same time as making money for their investors.[68]

Others include the Good Steward Fund (a Catholic 'fund-of-funds' hedge fund), an environmental hedge fund from Winslow Management Company and one focused on Catholic values, launched by Gabelli Asset Management Company. Since the launch of the first of its kind in 2005 by Shariah Funds Inc, the demand for Shariah compliant funds of hedge funds is increasing.

Professor Luigi Zingales, the Robert C. McCormack Professor of Entrepreneurship and Finance at the University of Chicago, argues that:

> *"Hedge funds are a very positive force in corporate governance. On the one hand, they have the flexibility to take relatively large positions in a short period of time to put pressure on underperforming companies. And they seem to achieve substantial results. On the other hand, they have strong incentives to deliver the results and are not tied down by the need to please corporations, like pensions funds."*[69]

Today, hedge funds are so mainstream they are acceptable to most investors, attracting investment, for example, from CALPERS – the California Public Employees Retirement System – which has a record of seeking long-term, sustainable returns.

Sovereign wealth funds

Background

SWFs are a heterogeneous group and serve various purposes.

Sovereign wealth funds (SWF) have existed since the 1950s – starting in 1953 with the Kuwait fund.

The Sovereign Wealth Fund Institute defines a SWF as:

> *"A state-owned investment fund composed of financial assets such as stocks, bonds, real estate, or other financial instruments funded by foreign exchange assets… they tend to prefer returns over liquidity, thus they have a higher risk tolerance than traditional foreign exchange reserves."*

SWFs are a heterogeneous group and serve various purposes. The International Monetary Fund (IMF) has categorized them according to their objectives:

- *stabilization funds*, where the primary objective is to insulate the budget and the economy against commodity (usually oil) price swings;
- *savings funds* for future generations, which aim to convert non-renewable assets into a more diversified portfolio of assets and mitigate the effects of 'Dutch disease';[70]
- *reserve investment corporations*, whose assets are often still counted as reserve assets, and are established to increase the return on reserves;
- *development funds*, which typically help fund socio-economic projects or promote industrial policies that might raise a country's potential output growth; and
- *contingent pension reserve funds*, which provide (from sources other than individual pension contributions) for contingent unspecified pension liabilities on the government's balance sheet.[71]

SWFs have increased their significance in recent years as states have used reserves from rising trade surpluses.

- IFSL estimates that stabilization funds and savings funds now control around $3 trillion in assets and that continuing high commodity prices could result in $5 trillion in these funds by 2010 and over $10 trillion by 2015.[72]
- In addition, there is an additional U.S.$6.1 trillion held in other sovereign investment vehicles, such as pension reserve funds, development funds and state-owned enterprises.[73]
- It has been predicted that, with other state-controlled firms taken into account, these countries will control $15-20 trillion in 5 years. The owners are 15 governments, and five of them control 70% of the total.[74]

Perceptions and responses

As SWFs have grown rapidly, they have also undergone an equally rapid swing in perceptions – from being seen as suspects who arouse concerns over national security to being welcomed as saviours of the western banking system.

As SWFs have grown rapidly, they have also undergone an equally rapid swing in perceptions – from being seen as suspects who arouse concerns over national security to being welcomed as saviours of the western banking system.

The rapid change has promoted a variety of responses from politicians:

> *"This is about protecting important industrial sectors."* German Chancellor Angela Merkel.
>
> *"We will protect innocent French managers from the extremely aggressive funds."* French President Nicolas Sarkozy.
>
> *"China Investment Corporation is entirely commercial."* China's Premier Wen Jiabao.
>
> *"We need to have a lot more control over what they do and how they do it."* Hillary Clinton.
>
> *"The British commitment to open markets means we will welcome sovereign funds."* UK government official.[75]

Although it is not technically a SWF but a state-owned business, the proposed takeover of P&O by DP World of Dubai led to questions being asked about the role and intentions of SWFs. U.S. lawmakers sought assurances that SWFs had no political goals while the EU also threatened to restrict SWF investments if they did not disclose more information about their intentions.

Since the credit crunch of 2007, however, the atmosphere has changed considerably as SWFs have poured billions into support for western banks and financial institutions.

Stephen Schwartzman, founder of Blackstone, in which the China Investment Corporation took a 9.4% share, has said that from a rational economist's point of view, *"it's difficult to think of how much worse off we would be in the current financial crisis without SWFs."*[76] EU Commission President José Manuel Barroso said that Europe must remain open to such inward investments.

> *"Sovereign wealth funds are not a big bad wolf at the door. They have injected liquidity and helped stabilise financial markets."*[77]

Charlie McCreevy, European Commissioner for Internal Market and Services, has said that investments which have the potential to compromise national security can already be blocked because EU member states are entitled to restrict Treaty freedoms on the basis of legitimate national security concerns and that the discussion on SWFs must not be used as an excuse to raise unjustified barriers and the free movement of capital.[78]

One former chairman told us that a non-political SWF like Norway's was *"God's gift as an investor."* But one less sanguine interviewee said that he feared that some SWFs would eventually be subject to political influence and be malign – *"we'd only seen the good side so far."*

Sovereign wealth enterprises (SWE) are now being set up as subsidiaries of SWFs. The Sovereign Wealth Fund Institute, an organization designed to study SWFs and their impacts, suggests that these are created for a variety of reasons. For example, SWEs may provide a vehicle with a less strict investment mandate than the parent SWF. The Institute adds that if an SWF has many sovereign wealth enterprises, it is harder to track their holdings.[79]

Given the growing presence and influence of SWFs, many have been calling for standards to be imposed on them, including provisions on investment strategy and transparency. A statement by G7 finance ministers and central bank governors said: *"We see merit in identifying best practices for SWFs in such areas as institutional structure, risk management, transparency and accountability."* [80]

In March 2008, responding to such concerns, the U.S. Treasury Department, along with the governments and SWFs of Abu Dhabi and Singapore, agreed to an *'Agreement on Principles for Sovereign Wealth Fund Investment'*. This included a statement that:

> *"investment decisions should be based solely on commercial grounds, rather than to advance, directly or indirectly, the geopolitical goals of the controlling government. SWFs should make this statement formally as part of their basic investment management policies."* [81]

This was followed by a wider agreement in September 2008 when a significant number of SWFs, as members of the International Working Group of Sovereign Wealth Funds (IWG), agreed to a set of voluntary set of principles and practices to be put forward for recommendation to their respective governments. The group described the *Generally Accepted Principles and Practices* as being aimed at:

> *"promoting a clearer understanding of the institutional framework, governance, and investment operations of SWFs, to help foster trust and confidence in the international financial system."* [82]

Role as 'steward'

So far the contribution of sovereign wealth funds has tended to be that of a patient long-term owner with dispersed but stable holdings. They strengthen the ability of managements to take a long-term view and appear to be primarily motivated by the prospect of financial return on the assets at their disposal, rather than by national or geopolitical considerations. They are therefore classic candidates to be responsible investors and to be stewards. Colin Melvin, speaking at the 'Tomorrow's Owners' event at Cass Business School in March 2008, said:

> *"At a meeting of the International Corporate Governance Network, which was devoted to the topic of sovereign wealth funds and their position as owners of companies in terms of exercising an interest in corporate governance, three of the sovereign wealth funds turned up I believe. All of them made presentations making it clear that they were not involved in any sort of control of companies and should be left alone. And then they were criticised by this group for not being involved in the control of companies! So they can't win! I think there is a huge opportunity here to get these funds working properly as responsible long-term owners rather than the arms of government…I would really like to see them bring in resources and engaging with companies responsibly, and hopefully that will happen."*

So far the contribution of sovereign wealth funds has tended to be that of a patient long-term owner with dispersed but stable holdings.

Bader Al Sa'ad, the managing director of the Kuwait Investment Authority, which started in 1953, is reported as saying:

> *"Kuwait has been a Daimler shareholder since 1969... BP shareholder since 1986, we are one of the most stable shareholders of these companies."* [83]

The Norwegian Government Pension Fund is often cited as a shining example of good practice. The management aims for a high degree of transparency based on international best practice, with the exercise of ownership rights founded on internationally accepted principles such as the *UN Global Compact* and the *OECD Guidelines of Corporate Governance* and *for Multinational Enterprises*. The fund is known for taking a stance on ethical issues. For example, in June 2006, it sold its more than $400 million in Wal-Mart holdings, criticizing the way the company treated its workers.

Institutional investors

Background

Institutional investors remain the giants of the investment community – still representing the vast majority of funds under management, although their dominance is being challenged by the newer owners – hedge funds, private equity and sovereign wealth funds. Institutional investors pool large sums of money and invest those sums in companies. They include banks, insurance companies, retirement or pension funds and mutual funds.

Institutional investors remain the giants of the investment community.

As we saw earlier, institutional investors handle huge sums. An IFSL study estimates that at the end of 2007 pension funds managed $28.5 trillion of assets, mutual funds $27.3 trillion and insurance assets $19.1 trillion.[84] It has been estimated that the largest 300 pension funds collectively held just over $10 trillion at the end of 2006.[85] The majority of the pension funds relate to public sector employees in state or local government. In the private sector, the General Motors pension fund – worth $118 billion in 2006 – is the world's largest company fund. By comparison, the Japanese state pension fund was some $935 billion in 2006.[86]

Like other types of shareholders, institutional investors are heterogeneous and display a range of behaviours. Traditionally, pension funds have been conservative investors, favouring blue chip stocks and government bonds, but this has changed in recent years. In 1993, equities made up 84% of UK pension funds' portfolios, but this had reduced to 67% by 2006. UK pension funds have moved into foreign equities, which by 2005 accounted for a larger share of assets under management than UK equities.[87] And in recent years, pension funds have become more adventurous. It has been estimated that institutional investors will invest as much as $1 trillion in hedge funds by 2010, up from around $360 billion in 2006.[88] Pension funds have also moved to some extent out of equities into bonds in order to get a better match to the liability profile of the funds.

Insurance firms, another major class of institutional investor, hold assets against potential claims. U.S. insurance companies account for a third of the assets held globally, with Japan and the UK holding around 14% each.[89] Regulatory requirements have meant that, in the wake of the dot-com bubble, insurance companies' assets, such as listed company shares, have had to be sold to maintain balance sheets.

For most individuals and smaller pension funds, the usual method for investing in companies is via a collective vehicle such as a mutual fund.[90] At the end of 2007 there were 66,350 mutual funds worldwide. U.S. mutual funds were managing assets valued at $12.0 trillion, while European fund managers had around $9.0 billion assets under management and $3.7 billion of assets were managed in the Asia-Pacific region.[91]

Institutional investors employ a variety of investment strategies, ranging from rules-driven approaches, which include index-tracking and momentum investing, to active management, where the fund manager invests in a limited number of companies, commonly based on judgments of whether a company has good growth prospects or on perceptions that the market has undervalued a company. Many funds operate a long only approach, buying shares they think have good prospects and selling when a target return as been achieved. Performance is usually judged relative to a benchmark.

Perceptions and responses

Unsurprisingly, for a diverse group, institutional investors provoke mixed reactions. Some are commonly perceived as the source of short-term, financial pressures on companies, ready to sell at the drop of a hat if company performance threatens to slide and their investment formula dictates such a sell-off. Others are seen as long-term, loyal, shareholders who want to know the company well.

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Part of the appearance of short-termism or detachment comes from the fact that institutions have to maintain other relationships than that with the investee company. Most critically, pension funds and mutual fund managers have fiduciary responsibilities to act in their clients' interests, often interpreted as primarily financial in nature. There is therefore a competitive pressure on institutions to perform as well as they can, or at least be in the pack. From this perspective, institutions need have little interest in the companies they invest in, other than as tools to generate returns.

However, two issues represent a challenge to this thinking. Firstly, shareholders such as pension funds and insurance firms are investing for the long-term. Their liabilities can stretch out 30 years or more. Secondly, funds that employ a rule-driven approach, such as use of trackers, remain as shareholders for as long as the company meets the rules.

Others are seen as long-term, loyal, shareholders who want to know the company well.

A senior representative of a private investment company, with block holdings in several major companies told us:

> *"We invest on a long-term basis. For example, one shareholding which we recently divested had been owned by us for more than 90 years. When we invest in a core investment, we invest for the long-term taking a hands on approach to the business. We aim to create value through being a key introducer, speaker and facilitator, all which being achieved by being the leading minority stake holder."*

In practice, many fund managers don't completely sell up when they don't like a company's prospects, but fine tune positions around a core holding, going overweight or underweight as they see fit, maintaining in effect a long-term interest in a company.

Role as 'steward'

If institutions deploy their immense scale effectively, they have the potential to remain the most powerful players in the investment system and perform a major role as stewards of the companies whose shares they own.

Some have argued that many of these large fiduciary institutions are what is termed 'universal owners'.

One consequence of the growth in institutional owners is that they now manage a large proportion of pension savings and investment on behalf of the population. Some have argued that many of these large fiduciary institutions are what is termed 'universal owners'.[92] A universal owner owns a small, but representative fraction of most of the companies in an economy, and therefore their ability to satisfy their fiduciary duties depend on the economy's overall efficiency and performance. Consequently, universal owners have a natural interest in sustainability because they either receive the benefits of companies managing their external impacts or suffer the negative consequences if they don't. As Colin Melvin says:

> *"The stakeholders are the shareholders and under the extension of the universal owner idea – we are all shareholders in society in effect because we have an interest in these large collectivist investment vehicles, which themselves have an interest in the companies. There's a circularity there."*

In accordance with such logic, institutional investors are increasingly demonstrating stewardship in various forms.

They are increasingly exercising their voting rights. Both the proportions of shares voted and the number of positively dissenting votes cast has increased in recent years. In the U.S., large public pension funds such as Calpers and TIAA-CREF have used their significant voting power to bring pressure on companies to improve their corporate governance. In Asia, it is still relatively rare to see the government-linked pension and provident funds exercising proxy voting rights, but several large state funds, including Korea's National Pension Corporation and the National Social Security Fund in China, are now developing corporate governance guidelines and/or proxy voting policies.[93]

Institutional investors are also engaging more with companies. The UK's National Association of Pension Funds reports that resources devoted to engagement have risen since 2001 and more than three quarters of its member funds had helped change executive remuneration, board membership or corporate strategy through engagement.[94] However, in its study in April 2008, McKinsey suggested that a CEO or CFO should devote time to communicating only with the most important and knowledgeable intrinsic investors that have professionals specialising in the company's sector. (Intrinsic investors were defined as those that take a position in a company only after rigorous due diligence of its intrinsic ability to create long-term value). The investors thought that executives should spend no more than about 10 percent of their time on investor-related activities, so management should be actively engaging with 15 to 20 investors at most.[95] Daniel Summerfield, of the Universities Superannuation Scheme (USS), made a similar comment from the institutional perspective. He observed that companies tend to talk primarily to their top 20 investors by size of holding, and argued that they should concentrate more of their communication efforts on those investors who hold for the long-term.

At a global level, long-term institutional investors have joined socially responsible investors under the banner of the *Principles for Responsible Investment (PRI)*. The Principles consist of six aspirational statements to which investors sign up, pledging themselves to be active, engaged, responsible shareowners. They include incorporating environmental, social and governance (ESG) issues into investment analysis and decisions and engaging with companies on ESG issues. Having been launched with around 60 organisations in 2005, by 2008 the PRI had attracted nearly 400 signatories with over $14 trillion in assets under management.[96]

Another initiative is the Carbon Disclosure Project, whereby major investors join together to ask around 3,000 leading companies to provide data on their carbon emissions and efforts to address climate change. Launched in 2000, the project originally drew support from investors with $4.5 trillion under management. Today it embraces over 300 investors with around $41 trillion under management – about a third of the world's total invested assets.

In these initiatives, institutions are following similar approaches to those of socially responsible investors (SRIs), the major difference being that institutions tend to be universal investors or at least investors in many companies, whereas SRIs only invest in companies they deem ethically, socially and environmentally responsible. Around 11 percent of assets under professional management in the U.S. – nearly one out of every nine dollars – are now involved in SRI. SRI assets rose more than 324 percent from $639 billion in 1995 (the year of the first *Report on Socially Responsible Investing Trends* in the United States) to $2.71 trillion in 2007. During the same period, the broader universe of assets under professional management increased less than 260 percent from $7 trillion to $25.1 trillion.[97]

In other related initiatives, brokers and investment experts are directing some of their expertise towards sustainable ends. For example, members of the Enhanced Analytics Initiative direct 5% of their brokerage commissions to firms that provided quality research that takes account of 'extra-financial' issues on long-term investment. The Initiative has 27 members with assets under management of $2.4 trillion.[98] The London Accord is a co-operative project designed to bring cutting edge investment research into the public domain to support debate on topics ranging from climate change to HIV/AIDS and enhance public decision-making. During 2007, the London Accord produced 24 reports on climate change that have become widely quoted and used by policy-makers, investment managers, economists, politicians, NGOs and the wider public.[99]

One challenge to institutions' aspirations to stewardship is the need to justify lending shares to hedge funds and others for the purposes of short selling or voting. The practice is defended on the grounds that it contributes to market efficiency and liquidity, reduces the risk of failed trades, and adds significantly to investors' incremental returns. The International Corporate Governance Network (ICGN) has a *Stock Lending Code of Best Practice* to address some of the concerns, which warns of risks associated with lending shares for voting:

One challenge to institutions' aspirations to stewardship is the need to justify lending shares to hedge funds and others for the purposes of short selling or voting.

> *"Misconceptions as to its nature have led to loss of shareholder votes in important situations, as well as to cases of shares being voted by parties who have no equity capital at risk in the issuing company, and thus, no long-term interest in the company's welfare.* ***It is bad practice to borrow shares for the purpose of voting. Lenders and their agents, therefore, should make best endeavours to discourage such practice.*** *Borrowers have every right to sell the shares they have acquired. Equally the subsequent purchaser has every right to exercise the vote. However, the exercise of a vote by a borrower who has, by private contract, only a temporary interest in the shares, can distort the result of general meetings, bring the governance process into disrepute and ultimately undermine confidence in the market."*[100] (emphasis is the authors' own)

Families, employees, foundations and others

In the case of very many private companies the majority of the shares are owned by families, employees or foundations. While in this section we look individually at families, employees, and foundations; the diversity of models stretches into mutual organisations and many customer and producer co-operatives.

Many companies are also owned by a combination of shareholders. INEOS, one of the UK's largest private companies, is 75% owned by its founder Jim Ratcliffe, and 25% by management and staff. Stemcor, the steel company, is likewise mainly owned by Ralph Oppenheimer and family, but 29% owned by management and staff. The fast growing clean fuels company, Greenergy, is owned by a mix of stakeholders – its directors; a major customer – Tesco; a multinational agricultural company – Cargill; and a private equity player, Barclays Capital.

Family-owned

Background

Family-owned businesses remain hugely influential in the business world. It has been estimated that family-owned businesses produce nearly 60% of global GDP or $5.5 trillion.[101] There is an overlap between family businesses and listed companies because many family companies have gone public.

It has been estimated that family-owned businesses produce nearly 60% of global GDP or $5.5trillion.

In the United States, for example, it has been estimated that family-owned businesses generated approximately 64 percent of America's GDP in 2007[102] as well as providing around 50% of U.S. jobs.[103] They account for 35% of the Fortune 500 corporations.[104] Family Business Magazine's list of the 100 largest family-owned businesses in the U.S. is headed by Wal-Mart, followed by Ford, holdings company Koch Industries Inc., agriculture distributor Cargill Inc., travel conglomerate Carlson Cos. Inc., and media conglomerate News Corp.[105]

In Europe, the Instituto de la Empresa Familiar estimates that more than 60% of EU companies are family businesses, including 25% of the leading 100 companies. The EU's 17 million family enterprises employ 100 million people.[106]

In the UK, a recent report estimated that family firms account for 31% of GDP, while providing employment to 9.5 million people – around 42% of all private sector employment.[107] It is estimated that 76% of the 8,000 largest UK companies are family businesses.[108] Family business forms the engine of the Finnish economy. At the end of 1999, family firms accounted for 79.7% of all Finnish companies.[109] Australian family businesses make up 67% of all private sector firms, and employ more than 50% of the workforce.[110]

In the UK, one of the largest family-owned businesses, and Britain's largest private company, is INEOS – the world's third largest chemical company with sales today approaching $45 billion. It is a relatively new company, set up in 1998, although its heritage can be traced back to 1815. By contrast, India's Tata group was founded by Jamsetji Tata in 1868. Revenues in 2007-08 are estimated at $62.5 billion, of which 61% comes from business outside India. The Group employs around 350,000 people worldwide.[111]

Until its demise in 2006, Japanese temple builder Kongo Gumi was believed to be the oldest family-owned business worldwide, in operation under the founders' descendants since 578. The oldest family-owned business still operating in the U.S. is the Zildjian Cymbal Co. of Norwood, MA. It was founded in 1623 in Constantinople and moved with the family to the United States in 1929.

In the U.S., although some large, family-owned businesses have issued shares to become public, several descendants of the founders of Fortune 500 companies still hold the majority of the stock in companies such as Wal-Mart Stores Inc., Ford Motor Co., and Anheuser-Busch Companies Inc. However while more than 30% of all family-owned firms survive the first generation, only 3% are in business into the fourth generation and beyond.[112]

The vast majority of Asian businesses – small and large – are owned and run by families. A 1999 World Bank study, *Who Controls East Asian Corporations?*, which looked at nearly 3,000 publicly traded companies in Hong Kong, Indonesia, Japan, Korea (South), Malaysia, the Philippines, Singapore, Taiwan and Thailand, found that families controlled more than half of East Asian corporations. Separation of ownership from family control was also found to be rare. However, the proportion has almost certainly increased since 1999, as more and more family companies have chosen to list.[113]

Perceptions and responses

Descendants of family-business owners are increasingly accepting the lure of lucrative buyout offers, whether from foreign companies trying to gain a foothold in a new market, large companies trying to absorb competitors, firms on the lookout to acquire new technology, or private equity funds.

However there are still strong perceptions that families are natural long-term stewards of companies – although there are questions as to whether family involvement always enhances performance. *"Family businesses have strong cultures and are less likely to be driven by short-term profits, traits that can make change difficult. Likewise, the emotional ties among family members can enrich the business experience – or complicate it,"* suggested a 2006 Stanford Business Magazine study, *The Decision Tree of Family Business*. Family interests and the interests of the business are often at odds. *"In a family business context, it is never just about money. Family members are prepared to sacrifice monetary gain for emotional reasons."* [114]

Others believe that family ties are generally positive for performance – at least in the sense of promoting prudence. Credit Suisse has found that European stocks with a significant family interest have outperformed their peers by an average of 8% every year since 1996.

Succession in family firms is often a problem. If the founders who drive the family firm are not replaced by a similarly driven successor, the business may decline. In many cases, families are bringing in professional managers to run businesses, but much depends on the skills with which they do this. Wates Group, one of the largest privately owned construction and development companies in the UK and established in 1897, did just that. Having bought out the two cousins whose children did not want to be involved in the business, it started to appoint experienced managers. This shift prompted the family to draw up a formal charter to clearly define its role. The family now meets once a year to devise a five-year strategy, setting out what it expects from the business. This is passed on to the board, which uses it as a framework for directing the business. The family also meets the board executives four times a year to discuss progress.

Role as 'steward'

Families which run or own their businesses for generations clearly have an inbuilt motivation to create the long-term value that constitutes one aspect of stewardship. When PricewaterhouseCoopers asked family business leaders what single achievement they would like to leave as their legacy, almost half of respondents spoke about wanting to ensure the sustainability of their companies.[115]

They can also have an inclination to be good citizens when they are deeply embedded in a locality and have family links which may extend back for generations.[116] In a report by GEEF (The European Group of Owner Managed and Family Enterprises) family companies' characteristics were summarized as having long-term horizons, a long-term employment culture and a willingness to make counter-cyclical investment.[117]

This natural focus on the future was endorsed by one of our interviewees, Mike Foster of Financial News, who said to us:

> *"The solution to Tomorrow's Company may actually be yesterday's company. Family owned companies are often seen as relatively conservative or sleepy. But because they resist the dash for maximum growth they are able to innovate and adapt at appropriate pace. The success of Germany's family-controlled Mittelstand companies illustrate the point."*

Families which run or own their businesses for generations clearly have an inbuilt motivation to create the long-term value that constitutes one aspect of stewardship.

Timberland provides a typical example of a case where family values influence CSR type policies. Speaking at the Tomorrow's Company lecture, 2005, Jeff Swartz, President and CEO of Timberland, said:

> *"For my family, business has never been about hiding behind the anonymity of the corporation, rather business has always been a passionate series of personal commitments and relationships. If you buy a pair of boots, what you carry with them is the passion of the people who designed it and built it and sourced it…we have worked to find water-based adhesives and we've borne the expense to eliminate toxins and to minimise emissions because as a corporation, as a for-profit listed company trying to make its way in the global economy, I believe we have a moral responsibility to be stewards of the air and water. I believe that as CEOs, we must deploy our creative and productive power to strengthen both our balance sheet and civic society at the very same time. This is the vision that guides what we do."* [118]

Families can also be powerful influences in quoted companies. Recently the Rockefeller family put pressure on the board of ExxonMobil – the successor to the original Rockefeller oil company of Standard Oil – calling on the oil company to invest more in low carbon energy.

However, threats to stewardship can arise when family businesses are listed and a potential conflict of interest comes into play between members of the family who own the majority of the shares and the minority shareholders.

Employee-owned

Background

Employee-owned companies form a minority of enterprises, but include some very successful and well respected businesses.

Employees can own a business in various ways, either directly or indirectly.

Structures vary; sometimes, employees may choose to form a co-operative that then acquires the business. Another common method is to set up an employee trust that holds shares on behalf of the employees. This can be a very flexible solution. The trust can hold the shares in perpetuity, or distribute them to individual employees, or a combination of both. It can also buy shares back from employees who want to sell (for example, when they retire). Using a trust may also be a good way to raise bank finance to acquire the shares. Employees can also own shares directly in their own names. One mechanism is for employees to acquire shares over time, perhaps as bonuses or part of their remuneration.[119]

Employee-owned companies form a minority of enterprises, but include some very successful and well respected businesses.

The technology company TTP has an unusual model which has contradicted many of the usual assumptions about the benefits of being listed. It has a record of spinning off new technologies into a separate entity either through a de-merger or trade sale. It regards 350 as the optimum size for a company of science and engineering graduates innovating in changing, multidisciplinary teams. It keeps its shareholding within the employee community, using internal bid and offer processes to transfer shares and extend ownership to new employees. Chairman Gerald Avison explains:

> *"De-merger, particularly if followed by a listing, leaves the shareholders with shares in the de-merged company, as well as in the parent company, and hence the opportunity for a capital gain for the employee shareholders, despite the (desirable) fact that the parent company remains privately owned. The trade sale leads to a special dividend. Both routes enable the company to build assets of value, to realise the value and to return some or all of this to the shareholders."*

In the UK, employee-owned companies include the John Lewis Partnership, Arup, Mott MacDonald, Martin Currie and eaga. Long established companies include Scott Bader and Tullis Russell. The Employee Ownership Association estimates the 'co-owned' sector in the UK has a combined annual turnover of £20-25 billion.[120]

In America, there are approximately 4,000 companies which are majority-owned and 2,500 which are 100% owned by their Employee Stock Ownership Plan (ESOP).[121] They include the supermarket chains Publix Supermarkets and Hi-Vee with over 140,000 and 50,000 employees, respectively, as well as such well-known names as Nypro and W.L. Gore.

Perceptions and responses

Research has shown that these companies perform as well, and often better, than companies with more traditional ownership models.

Employee-owned companies are generally well regarded, particularly when the active participation of employees in the management of the business is also a feature. In Tomorrow's Company's report on Employee Ownership, it was found that *"Employee ownership on its own does not make a difference to performance. There is a positive outcome on performance when employee ownership is combined with high levels of employee participation."* [122] This was confirmed by 'The Short Inquiry' into employee ownership undertaken for 'The All Party Parliamentary Group on Employee Ownership' in the UK. A number of respondents stressed the need for the model to wholeheartedly combine the incentive of ownership with participatory involvement. It said that this is the combination that unlocks enhanced performance, either by increasing labour productivity or by lowering absenteeism rates, reducing employee turnover, improving job satisfaction and improving the quality of output.[123] In the U.S., Corey Rosen, John Case, and Martin Staubus, in discussing their book on employee ownership, state *"When employees own a stake, the attitude of a company changes – and so does its bottom line."* [124]

However, employee ownership has its critics. Some doubt whether such companies have the ability to make the right decisions or to make them quickly enough.

Others counter that employee ownership does not mean that everybody has to be consulted to make every single decision, anymore than owners are consulted in a listed company. Patrick Burns of the Employee Ownership Association (EOA) in the UK stresses that his member organisations have conventional management structures. *"These companies have strong, firm, professional management teams who do what managers are supposed to do. This isn't democracy gone mad. And it's not shop floor versus management,"* he says. Managers are shareholders too, he points out.[125]

Research has shown that these companies perform as well and often better than companies with more traditional ownership models. Equity Incentives, which provides a share plan service to private and quoted companies, has compared the financial performance of employee-owned companies with those listed on the FTSE. Since 1992 it shows £100 invested in an index of these companies would have been worth £349 by the end of June 2003 while the same £100 invested in the FTSE all-share index would only have grown to £161.[126]

The Employee Ownership Association carried out a survey in 2005 that revealed that 72% thought staff worked harder under a co-ownership structure, 81% said they took more responsibility, 49% thought competitiveness was enhanced and 44% confirmed profits were higher.

Role as 'steward'

Stewardship tends to come naturally to employee owners.

Stewardship tends to come naturally to employee owners. They want to continue working at their company so value long-term success. They also want to work for a popular and respected company, and so value responsibility and good citizenship.

A spokesperson for the John Lewis Partnership said:

> *"Our ownership structure means that we can invest for the long term. We don't have to answer to external shareholders so we are not under the same pressure that quoted companies experience to deliver returns over short time frame."*

The Partnership is currently investing over £1 billion in the expansion of John Lewis and Waitrose, and has also come first in the Which? survey of the nation's favourite retailers.

In Tomorrow's Company's report on Employee Ownership, it was found that:

> *"Companies which fuse the roles of employees and shareholders while living up to the social vision of their founders may have the best chance of doing business in a way that makes equal sense to staff, shareholders and society. There is evidence that the next generation of talented employees are looking for different things from work. It may be that employee owned companies are better placed to attract and keep talented people, particularly because of their ability to generate trust."* [127]

Foundation-owned companies

Background

Foundation ownership is found mainly in Northern Europe.

Foundation ownership is found mainly in Northern Europe – particularly in Denmark, Germany, Sweden, Norway, the Netherlands, and Switzerland. Examples include the following:

- **Bosch**, is one of Germany's largest industrial foundations and typifies the complex clusters of companies that characterise foundation-controlled businesses. Set up in Stuttgart in 1886 by Robert Bosch, it now operates in roughly 50 countries, has some 271,000 associates and sales of over €46 billion. In June 1964, the heirs of Robert Bosch transferred control of the majority of their shareholdings to Robert Bosch Stiftung GmbH, a charitable foundation that now holds over 90% of the share capital of Robert Bosch GmbH and uses its dividends for purposes such as medical care, social work and education. The majority of voting rights are held by Robert Bosch Industrietreuhand KG, an industrial trust which carries out the company's entrepreneurial ownership functions. The remaining shares are held by the Bosch family and by Robert Bosch GmbH.[128]
- **IKEA**, which has 231 stores in 24 countries, 118,400 co-workers and nearly €20 billion in revenues, has been owned by a foundation since 1982 because its founder, Ingvar Kamprad, wanted to create an ownership structure that promoted independence and a long-term approach.[129]
- **Novo Nordisk**, a Danish pharmaceutical company and leader in diabetes care, with sales of around £4.5 billion, is a listed company with an ownership structure designed to drive high performance, support humanitarian causes and invest like a venture capital fund in innovative start-ups. The company is listed so it can attract external shareholders, but a majority of voting shares are held by another company in its group, Novo A/S, which also acts as the venture capital firm. Novo A/S in turn is owned by the Novo Nordisk Foundation, a non-profit institution, which makes contributions to scientific, humanitarian and social progress.[130]
- **GrupoNueva**, based in Chile, which has sales of around $1.7 billion, has all of its stock owned by the VIVA Trust which ensures that administration of the group's affairs is consistent with the vision and values promulgated by founder Stephan Schmidheiny. The dividends GrupoNueva pays to VIVA are reinvested in the improvement of Latin American society.[131]

Perceptions and responses

It might be expected that foundation-controlled companies would lack the performance edge of those whose most influential shareholders are motivated by profit. However, studies on Danish data over the period 1982-1992 *(Thomsen 1996, 1999)* and a study on German data *(Herrmann and Franke 2002)* found the economic performance of foundation owned companies to be no worse or even slightly better than that of companies with more common ownership structures.[132]

Role as 'steward'

Stewardship is strong among companies owned by foundations. Freed from the need to generate ever increasing value for external shareholders, their motivations can be focused on steady and sustainable business performance allied to responsible social and environmental activity and philanthropy.

The establishment of this special ownership structure has usually been driven by a desire to safeguard the long-term future of the company and – in many cases – to maintain the vision of a founder.

> *"When a company is a family affair, when there is only one owner, a critical moment always arrives regarding succession. In my case this challenge was solved with the creation of the VIVA Trust. 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. The basis of my conviction – and the very reason for the creation of VIVA – is that a company that manages its business in a responsible way, with consideration for its own employees, its neighbors, for society and for the environment will be more profitable, much more economically solid than an irresponsible company. Working responsibly is an investment and will have its rewards; this could be described as acquiring a social license to operate."* Stephan Schmidheiny, GrupoNueva.[133]

Freed from the need to generate ever increasing value for external shareholders, their motivations can be focused on steady and sustainable business performance allied to responsible social and environmental activity and philanthropy.

Part 6: Implications and questions

We do not believe it is possible to categorise groups of investors as ‘good’ or ‘bad’. It is about the extent to which shareholders are aligned with the long-term interests of the company.

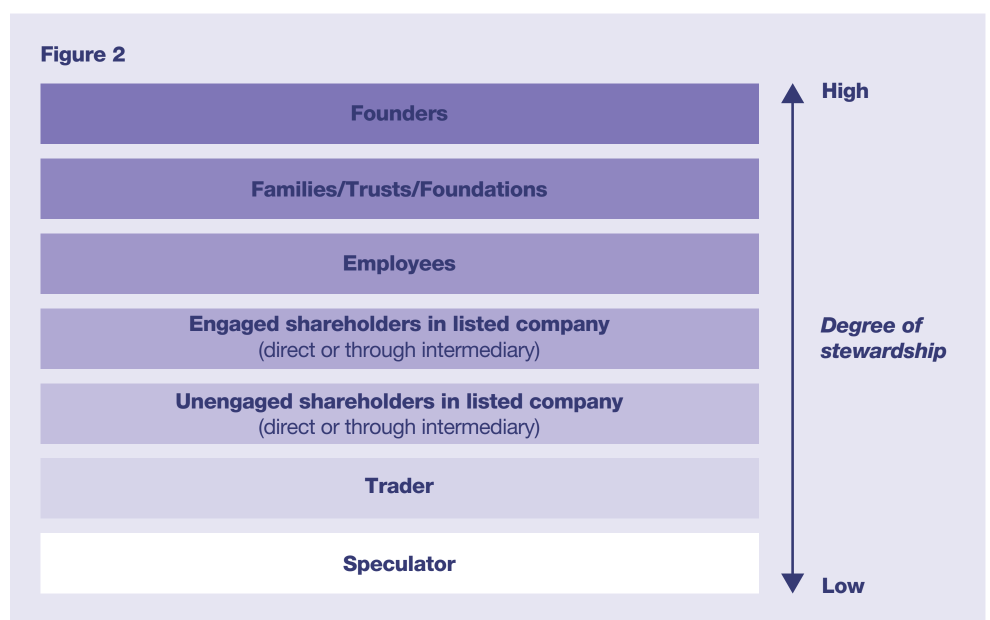
Contrary to some perceptions, we do not believe that it is possible to categorise whole types of investors as either 'good' or 'bad'.

In the *Tomorrow's Global Company* report, the companies involved in the inquiry were clear that financial success and sustainability are two sides of the same coin. As Peter Drucker said, profit is not the rationale of business decisions, but a test of their validity. Sophisticated investors, such as Warren Buffett, have always linked the principles of fundamental valuation analysis, first formulated by his Columbia Business School teachers Ben Graham and David Dodd, and the management principles that define the proper role of corporate managers as the stewards of invested capital. Buffett also recognises that superior long-term results can flow from earning the trust of communities.[134]

Tomorrow's Company believes that any company's success depends on building and maintaining strong and constructive relationships with its major stakeholders – shareholders, employees, communities, suppliers and customers. The process of nurturing and developing these relationships is what we have described as 'stewardship' – the careful and responsible oversight of an organisation with a view to its long-term strength and hence its ability to use its innovative capacity, skills and footprint to help address the social and environmental challenges we all face. Stewardship implies that the business should be around for generations and that those who are responsible for it are also responsible for handing it on to the next generation in better shape than they inherited it. The measure of success that goes naturally with stewardship is a measure of long-term health – of shareholder value, certainly, but shareholder value grown from nurturing the many relationships of the business.

Contrary to some perceptions, we do not believe that it is possible to categorise whole types of investors as either 'good' or 'bad'. Nor is it about 'owning' versus 'trading': a healthy economic system will always contain both elements. It is more about stewardship behaviours. It is about the extent to which shareholders are aligned with the long-term interests of the company.

We have plotted the relationship between types of shareholders and their tendency to exhibit the quality of stewardship along something we have called the **stewardship spectrum** (Figure 2). Their position along the spectrum is not absolute. But this spectrum indicates the likely position of a type of shareholder based on what we have learned about their behaviour during this initial phase of research for the programme. At one end of the spectrum, founders or founding families tend to be very strong in their stewardship attributes, while at the other end of the spectrum, speculators exercise no stewardship responsibilities whatsoever.



This research has raised a number of questions about what the differing approaches to ownership portend for the financial system, for society, for companies and for policymakers and regulators.

Can the global economy be a positive force for the natural environment and for social and political systems? Or is there a growing risk that speculative activity in the 'casino economy' will result in needless wealth destruction and leave social and environmental challenges unaddressed.

As we mentioned at the beginning of this report, a key conclusion from the Tomorrow's Global Company inquiry was that:

> *"Providing returns to investors and ensuring the future health of the environment and society are not at odds with each other."*

However the report also indicated that such a 'win-win' outcome depended on having a broadly defined vision of success that encompassed both shareholder returns and social and environmental goals. Achieving such a shared vision depended on open communication and building trust.

Our perception is that many shareholders are buying into such a broad and sustainable vision of success. We see this, for example, in the way that institutional investors have stepped up their engagement and become more focused on environmental, social and governance (ESG) issues, converging with the interests of ethical and SRI funds. Initiatives such as the Principles for Responsible Investment, the Dow Jones Sustainability Indexes and the Carbon Disclosure Project all suggest that sizeable numbers of investors now believe that ESG issues matter for shareholder value as well as for the world's wider well-being. This is leading to a wider definition of responsible investment that not only includes screening investments on the basis of ethical or environmental issues but advocacy, engagement and community investing. As one former chairman put it, the central question is what drives investment. Is it long or short-term? And if long-term, does it embrace ESG?

So will investors continue to evolve towards an approach that integrates ESG and financials? Will 'fiduciary responsibility' come to mean rewarding good ESG performance? Does it also mean penalising poor ESG performance? Will the approach taken within the cohort of 'responsible investors' be to toughen up engagement in order to change company's behaviour, or will more of them, including major investors, be prepared to divest their shareholdings in companies with particular perceived shortcomings? And will the growing cohorts of investors such as sovereign wealth funds and private equity do the same?

Meanwhile, what of the shareholder pressures that might lead companies to adopt a less sustainable approach? Companies are constantly vulnerable to distraction from their focus on long-term strategy in the face of volatile shifts in share price, as speculators move their stock and 'black boxes' automatically do the rest. However, this need not be an 'either/or' situation. Speculators are an inevitable part of an efficient market ecology. Indeed the skills of players such as hedge funds can act to increase transparency, highlighting instances of over or undervaluation. The focus and expertise being applied by players from the 'casino economy' can often act as a catalyst for more decisive action by directors and greater engagement by other investors. There is nothing wrong with speculation per se: it is part of stock market activity – but it is just not part of the stewardship process. That said; there is a fine line between legitimate trading and market abuse. Regulatory vigilance is needed more than ever in order to ensure that abuse does not prosper. Market liquidity is one precondition for the operation of our economic, social and ecological system. But another crucial element is the appropriate balance between

the strength of the 'real', 'financial' and 'casino' economies. Some of the wider issues facing society, the economy and the environment require concerted action in which companies will play a central part. However, these take time to resolve. If the activities of the 'casino economy' grow disproportionately strong, they may undermine the ability of companies to sustain themselves over the long-term and to play their full role in addressing these problems.

So how can the right balance of behaviours be achieved?

There is a lack of alignment between the interests of some investors and companies. So who should adapt: companies, investors, or both?

Will companies need to adapt?

Today, when companies have an array of different shareholders with differing motives, they can no longer treat all investors the same. Ira Millstein summarises the new situation thus:

Today, when companies have an array of different shareholders with differing motives, they can no longer treat all investors the same.

> *"Although all the new organizations may indeed be technically defined as shareholders, what does each of them value? What is shareholder value between one investor who will profit from driving the share price down, another who wants to take the company private, another looking for instant cash, and one more who is thinking about long-term growth? How do boards serve many masters? Can they do so? Which shareholders? With what intentions? What we are now learning is that the notion that directors owe a fiduciary duty to be "fair" to all shareholders is turning out to be a quite imprecise guide to directors. We are entering new territory."* [135]

So 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 to a long-term intrinsic investor?

Dogmatic views for or against particular groups of investors are unhelpful. CEOs need to be proactive in deciding which of their owners are truly aligned with their long-term interests and then use their influencing skills to build the confidence of those core investors.

Stephen Davis, Project Director, Millstein Center for Corporate Governance and Performance, Yale School of Management, says companies looking to keep their core investors loyal should learn the art of persuasion – and some of the engagement techniques – from politicians:

> *"Corporations need to borrow strategy from the political world. Politics is about persuasion. That used to be simpler when you knew all the players, and they were local…But the UK corporate governance system is on a knife-edge. 40% of companies are now owned by non-residents. These people are not part of the phone trees or the typical meetings. They work from offices thousands of miles away. Companies need to adopt approaches that go beyond the conventional. If you are facing a shareholder who is after you, you might try to appeal over the heads of fund managers to the ultimate providers of the capital."* [136]

So should companies raise their game in terms of investor relations, being more proactive in seeking out and engaging with their major shareholders – going beyond fund managers in doing so?

And it is not just the expectations of shareholders which need to be understood and managed. The range of influences also involves NGOs galvanising shareholders to put forward resolutions on key issues, as well as customers and employees expecting companies to be transparent about the social and environmental impacts of their operations and products.

Or will the attitudes of investors change?

Investors can also learn from each other.

The PE model is often based on buying companies, turning them around and then selling them back into public ownership. Paradoxically, the symbiotic relationship between the private equity markets and the quoted markets could be a positive influence on the sector's approach to sustainability issues. As public pressure and concern grow about social and environmental impacts it will have an effect on the way a company is valued. For PE owners as for everyone else seeking an exit it makes no sense to ignore the reputational risk and effect on the value of companies of not addressing these issues.

Investors can also learn from each other. For example, institutional investors can learn some of the methods of private equity and family business in holding managers to account and making sure remuneration is well-judged and not excessive.

Perhaps in years to come, we will talk instead of 'stewardship activism'.

When pension funds and other institutional investors invest in hedge funds – or indeed private equity – should they be better at setting mandates which hold those investment vehicles to account? And what should the institutions do to ensure that the methods used by those they invest in do not contradict their own purposes as custodians of their members' savings? Furthermore, should they not ask whether their stock lending is justified in the light of their overall objectives?

Also how much of the debate about 'alternative' investors (PE, hedge funds, SWFs) is about protecting vested interests and 'traditional' models of investing? PE, hedge funds and (potentially) SWFs do things in different ways from 'traditional' investors. They have developed techniques that have learned from others' experience and they do things that traditional funds are restricted from doing. They are playing by different rules while attracting funds from traditional approaches, so perhaps the debate in part is triggered by traditional investors trying to protect their positions?

Among all investors, it is to be hoped that the pain of the credit crunch and increasing concern over social and environmental issues will lead to a desire to be good stewards – to promote the long-term sustainable success of their companies. We have noticed that talk of 'shareholder activism' is now being supplemented by discussion of 'stakeholder activism' – but perhaps in years to come, we will talk instead of 'stewardship activism'.

And what can companies and investors learn from each other?

Companies can learn from highly active and challenging investors about the importance of communications with a variety of shareholders and stakeholders

In an age of increasing investor engagement, it is also important to recognise that companies and investors can learn from each other. For example, companies can learn from highly active and challenging investors about the importance of communications with a variety of shareholders and stakeholders. Stephen Davis gave the following example, in which the shareholders consulted were also stakeholders:

> *"Eric Knight of Knight Vinke is interesting. He sees his work as stakeholder activism not shareholder activism, when he goes after a company. He reckons he would not get far if he were just appealing to other shareholders. He engages all sorts of people. When he was going after Suez over the performance of Electrabel, he spoke to all sorts of people including mayors of Belgium whose towns owned stakes in Electrabel. The company has to figure out how to go over the heads of those who own the short-term funds."* [137]

And as 'Generation Y' become the directors and investors in the future, with social and environmental concerns high on their agenda, perhaps they will bring with them the leadership, focus and drive needed to address these concerns from within the organisations they work for – or own shares in – and create a closer alignment.

What regulation or frameworks are needed to underpin stewardship to support global growth and help companies address sustainability issues?

Our researches have suggested several areas in which frameworks of mandatory regulation or self-regulation may be able to encourage more of a 'stewardship' approach to investing.

One such area is that of transparency over the stakes that investors hold and the intentions they have in respect of them. This has been particularly relevant to debates over the newer classes of investors, such as PE, hedge funds and SWFs, which have been variously perceived to be either heroes of free enterprise or villains exploiting imperfections in the market to their own ends.

The negative perceptions have largely arisen as a result of lack of transparency. Does this SWF have a hidden political motive? Is that hedge fund about to sell company X? Is this PE firm planning to break up company Y? In a world where technology has made real time information pervasive, participants are naturally suspicious of new players whose activities or motives are not clear.

There is a common pattern; as each new class of investor grows in influence, with activities that are not open to public scrutiny, there quickly follows a hubbub of concern over its motives, along with calls for mandatory regulation or at least new frameworks for self-regulation. In fact, these investor class labels cover widely different types of activity with differing objectives. However, it is the case that investors' objectives are not always clear. So is greater regulation justified, and if it is, what should these frameworks look like?

The principle of stewardship is served by progress towards greater openness.

Clearly a balance needs to be struck between the right of a company to know who owns its equity and the right of an investor to pursue a value-creating strategy in confidence, without sharing the information and thus the rewards with the rest of the market.

However, all our work so far points to the importance of transparency and suggests that the principle of stewardship is served by progress towards greater openness. Indeed, several regulators, including the U.S. Securities and Exchange Commission (SEC)[138] and the FSA, have recently tightened regulations, for example on disclosure thresholds, indicating that this is an area where new rules are needing to be written as the investment system evolves rapidly.

So what is the right balance between transparency and confidentiality – and what, if any, further regulation is needed to strike it?

If ownership is polarising into the intensely active and the passive, can regulators and the law continue to treat all types of investor in the same way? Or is more regulation needed to enhance transparency and prevent market abuse? Alternatively, should the approach be one of allowing the market to operate freely and encouraging the establishment of voluntary frameworks on a global basis?

Will the fall-out from the sub-prime crisis and the deep questions it has raised about the fragility of the financial system result in new frameworks being created? Will these frameworks, whether voluntary or imposed, be able to strike a balance between the need for liquidity and the need for a sound and stable financial environment to support the companies in the 'real economy' – companies on whose expertise and financial strength we are relying on to help address the social and environmental issues we face? How effective and how widely adopted are the various codes for self-regulation?

A specific issue we have repeatedly encountered in discussion is that of shares being borrowed for trading or speculative purposes, or for use in order to gain voting rights.

What does this do for the concept of stewardship? Is the practice justified by the fee income derived from it – or should wider stewardship considerations apply? Indeed, should investors be allowed to vote on company directors and other critical issues when they only hold borrowed shares?

At the same time as global economic growth is continuing and competition intensifying for sources of energy, raw materials and water, foreign ownership of key industries and infrastructure assets is increasing, by SWFs in particular. Whether this is of concern or not to the countries affected will depend on the motives of the new owners – motives which, as we have noted, are not always made known. Some countries will be affected favourably, others less so.

Countries have every right to safeguard national security and protect themselves against excessive dependence – but is this anxiety being used as an excuse to engage in broader protectionist policies? In the light of these fears, is it now necessary to reassess the case for public (state) ownership of strategically important industries?

Meanwhile, large companies are becoming global citizens; locating according to business logic, registering where the tax and regulatory regimes suit them, accepting investment from the most convenient source, and recruiting talent and frequently customers on an increasingly global basis.

So does the country of origin of a company's ownership matter any more, other than in the case of defence industries and other nationally strategic industries where interruption of supply could be jeopardised by foreign ownership? On the other hand, could foreign ownership more likely become a guarantee of economic interdependence and therefore of peace? Are there implications for regulators in the future?

Another significant issue for regulators in the future is the balance of power between different investors and directors, and the rights accorded to shareholders in different jurisdictions. We have pointed to the risk in the dispersed shareholding model that directors can be too free to serve their own interests at the expense of the company and its shareholders. Equally in the blockholding model, minority shareholders are often denied the rights they need to give them a fair voice to hold directors to account. These issues have prompted much debate, for example in the EU.

So can a shared view of shareholder democracy be reached? And how might this be addressed through regulation or other means?

Another significant issue for regulators in the future is the balance of power between different investors and directors, and the rights accorded to shareholders in different jurisdictions.

Part 7: Looking ahead

A new focus is needed on what it really means in practice to provide for, and encourage stewardship.

Stewardship of our companies is a part of stewardship of our future well-being.

With every new intermediary in the value chain that links savers to investment performance, there is an inevitable erosion of the sense of stewardship. In the global investment landscape, the value chains are now heavy with intermediaries, some of whose motives are unclear and some of whose activities can be destructive to long-term wealth creation and sustainability. As the 'casino economy' develops, a conscious effort is needed to review its impact on the rest of the economy, and on the health of the society and the environment on which we all depend.

In undertaking this review we need to move beyond the sterile business of demonising particular categories of investor, and develop a new focus as to what it really means in practice to provide for, and encourage stewardship. Among other things, this may well mean an end to the assumption that all investors can be treated in the same way, by companies or regulators.

We need to encourage and support those investors who do acknowledge the importance of stewardship. Stewardship of our companies is a part of stewardship of our future well-being.

Acknowledgements

We would like to thank…

I have long believed that ownership matters – which is why I'm so pleased to welcome *Tomorrow's Owners*, which not only sets out what ownership means, and why and how it is so important, but also gives us a new way of shaping our understanding of the importance of ownership in the context of wider concerns and impacts.

I'm therefore delighted to thank all those who have worked so effectively – in Tomorrow's Company and beyond – on this report, and look forward to the next phase of *Tomorrow's Owners* on which we will now be able to build.

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Tony Manwaring
Chief Executive
Tomorrow's Company

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