

# Business Ethics

## P13601



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**LECTURE 4**



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# Shareholders and Business Ethics



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# Today's Lecture



- Discuss the shareholder as a key stakeholder in business
- Ethical issues in Corporate Governance
- Shareholders and corporate social responsibility

# Introduction



- Ethics and CSR often seen as protection of stakeholder interests from **shareholder primacy**
- But shareholders (a) can be victims of unethical behavior too, (b) can choose to voluntarily side with stakeholder interests
- The **rights** of shareholders: ethical responsibilities of governments, firms and financial markets toward shareholders
- The **ethical values** of shareholders: shareholders' goals and interests beyond profit maximization
  - **Socially responsible investing (SRI)**
  - **Shareholder activism**

# Owners and Control



- Traditionally ownership = control
- Up until the early 20<sup>th</sup> century, firms were generally run by their owners
- Modern corporations are more often managed (controlled) by “agents” (managers) who have a fiduciary duty to fulfil the goals and mission given them by its “principals” (shareholders)
- Exceptions exist: many SMEs and family-owned business, and even some corporations, are still run by their owners or primary shareholders

# Owners vs. Shareholders



- Often used interchangeably
- However, a corporation is a legal entity (“artificial” person)
- Corporation assets are owned by the corporation, not shareholders
- Employees are employed by the corporation, not shareholders
- Publicly traded corporation: distributed (dispersed) shareholding (esp. in Anglo-American model)
- As distribution of shareholding increases, shareholders become less “owners”, managers become more powerful

# Corporate Governance



“Corporate governance describes the **process by which shareholders seek to ensure that ‘their’ corporation is run according to their intentions.** It includes processes of **goal definition, supervision, control, and sanctioning.**

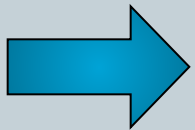
In the **narrow sense** it includes shareholders and the management of a corporation as the main actors, in a **broader sense** it includes all actors who contribute to the achievement of stakeholder goals inside and outside the corporation.”

Parkinson (1993: 157)

# Shareholders' rights



- The right to sell their stock
- The right to vote in the general meeting
- The right to certain information about the company
- The right to sue the managers for (alleged) misconduct
- Residual rights in case of the corporation's liquidation



Does **NOT** include a right to a certain amount of profit



# Shareholders' expectations



- To be able to make informed investment decisions, shareholders need proper information
- Transparency: completeness, understandability, and correctness in information
- Markets and investment decisions also require a certain level of trust
- Trustworthiness of management: competence and integrity

# Ethical Issues



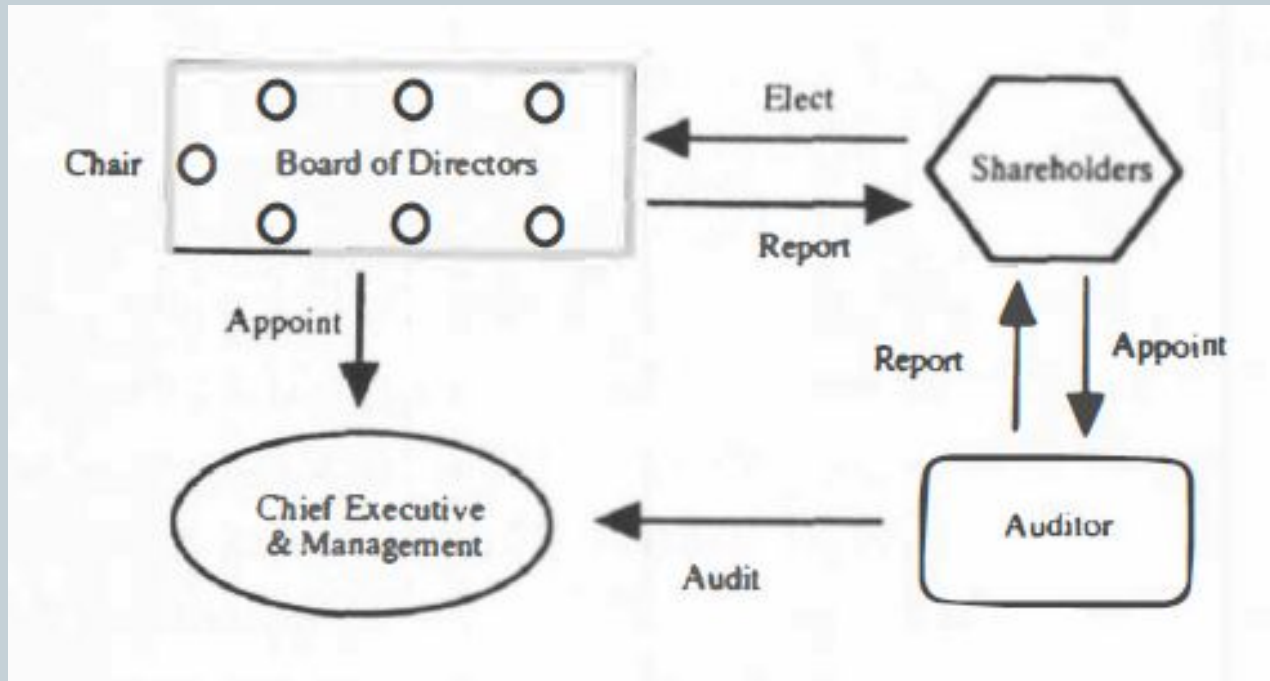
- Agency problem: Misalignment of interests of agents and principles
- Opportunistic behavior by managers (e.g. increase bonus, power & prestige, or value of stock options) can lead to a variety of unethical and/or illegal behavior:
  - Accounting fraud
  - Detrimental M&As
  - Excessive executive compensation
  - Insider trading
- All at the expense of shareholder value

# The Board of Directors



- A separate body that supervises and controls management on behalf of shareholders
- Two types of directors:
  - **executive directors:** are actually responsible for running the corporation (e.g., CEO, CFO, COO, etc.)
  - **non-executive directors** are supposed to ensure that the corporation is being run in the interests of shareholders (aka **independent** or **outside** directors)
  - Drawn from outside the corporation
  - No personal financial interest in the corporation
  - Appointed for limited time
  - Competent to judge the business of the company
  - Sufficient resources to get information

# Corporate Governance



Anglo-American model

# Corporate Governance Models around the World

	Anglo-American model	France, Italy & Germany	Russia	India	China	Brazil
Ownership structure	Dispersed	Concentrated, interlocking pattern of ownership between banks, insurance companies, and corporations	Concentrated in either the hands of owner-managers or the wider circle of employees in joint-stock corporations	Highly concentrated; recent tendency to more dispersed ownership	Highly concentrated in state-owned companies; fairly concentrated in private enterprises	Highly concentrated ownership by family owned business groups; wave of privatization since 1990 has reduced state ownership
Ownership identity	<ul style="list-style-type: none"> <li>• Individuals</li> <li>• Pension and mutual funds</li> </ul>	<ul style="list-style-type: none"> <li>• Banks</li> <li>• Corporations</li> <li>• State</li> </ul>	<ul style="list-style-type: none"> <li>• Owner-managers</li> <li>• Employees</li> <li>• State</li> </ul>	<ul style="list-style-type: none"> <li>• Families</li> <li>• Foreign investors</li> <li>• Banks</li> </ul>	<ul style="list-style-type: none"> <li>• State</li> <li>• Families</li> <li>• Corporations</li> </ul>	<ul style="list-style-type: none"> <li>• Family owned business groups</li> <li>• State</li> </ul>
Changes in ownership	Frequent	Rare	Frequent, but decreasing tendency	Traditionally extremely rare, but recently changing	• Rare, but increasingly dynamic	<ul style="list-style-type: none"> <li>• Rare</li> <li>• Increasing influence of foreign investors</li> </ul>
Goals of ownership	<ul style="list-style-type: none"> <li>• Shareholder value</li> <li>• Short term profits</li> </ul>	<ul style="list-style-type: none"> <li>• Sales, market share, headcount</li> <li>• Long term ownership</li> </ul>	<ul style="list-style-type: none"> <li>• Profit for owners</li> <li>• Long term ownership</li> </ul>	<ul style="list-style-type: none"> <li>• Long term ownership</li> <li>• Growth of market shares</li> </ul>	<ul style="list-style-type: none"> <li>• Long term ownership</li> <li>• Sales, market share</li> </ul>	<ul style="list-style-type: none"> <li>• Long term ownership</li> <li>• Profit for owners</li> </ul>
Board controlled by	<ul style="list-style-type: none"> <li>• Executives</li> <li>• Shareholders</li> </ul>	<ul style="list-style-type: none"> <li>• Shareholders</li> <li>• Employees</li> </ul>	<ul style="list-style-type: none"> <li>• Owner-managers</li> <li>• Other insiders</li> </ul>	<ul style="list-style-type: none"> <li>• Owners</li> <li>• Other insiders</li> </ul>	<ul style="list-style-type: none"> <li>• Owners</li> <li>• Party/the state</li> </ul>	<ul style="list-style-type: none"> <li>• Owners/ shareholders</li> </ul>
Key stakeholders	<ul style="list-style-type: none"> <li>• Shareholder</li> </ul>	<ul style="list-style-type: none"> <li>• Owners</li> <li>• Employees (trade unions, works councils)</li> </ul>	<ul style="list-style-type: none"> <li>• Owners</li> <li>• State</li> </ul>	<ul style="list-style-type: none"> <li>• Owners</li> <li>• Customers in overseas markets</li> </ul>	<ul style="list-style-type: none"> <li>• Owners</li> <li>• Guanxi-network of suppliers, competitors and customers (mostly) in overseas markets</li> </ul>	<ul style="list-style-type: none"> <li>• Owners</li> <li>• Customers in overseas markets</li> </ul>

# Corporate Governance Problems



Numerous reasons why corporate governance arrangements fail too work:

- CEOs who have too much power (CEO & Chairman positions held by the same person)
- Directors' lack of independence (conflicts of interest)
- Failure of directors to stand up to executives (lack of courage or strength)
- Auditors want to maintain a good relationship with management (conflict of interest)
- Auditors also offer consulting services to firm (conflict of interest)

# Corporate Governance Reforms



In the wake of alarming corporate scandals, CG reforms have been introduced in the US and most European countries. These tend to focus on:

- Separation of CEO and Chairman positions (often recommended but not required)
- Number or proportion of independent outside directors
- Independence of audit committee
- Independence of compensation committee
- Disclosure of compensation
- But CG problems persist

# Lehman Brothers



- Lehman Brothers and Goldman Sachs had similar boards
- Both had made many recommended changes
- Lehman Brothers declared bankruptcy in 2008, during the Global Financial Crisis
- Why did its board fail to prevent this disaster?



# Whistleblowing



- When an employee makes information about misconduct by their employer public
- Many corporate (and government and NGO) scandals came to light thanks to whistleblowing
- Whistleblowing directly to the press or the public is becoming more common

# Examples of Whistleblowing



Some recent and prominent examples of whistleblowing include:

- Jeffrey Wigand revealed that tobacco companies were fully aware of the harmful health effects and addictive nature of smoking cigarettes
- Sherron Watkins, Vice President of Corporate Development, helped expose accounting fraud at Enron
- Cynthia Cooper, Vice President of Internal Audit, exposed a \$3.8 billion fraud at WorldCom
- Edward Snowden

# Whistleblowing



- Whistleblowing can be facilitated by creating telephone hotlines that allow employees to anonymously “tip off” senior managers or independent directors
- Anonymity is important because whistleblowers face many risks and hardships
- Some countries, but not all, offer legal protection for whistleblowers
- In some countries whistleblowing is financially rewarded

# Whistleblowing Example



- Sherry Hunt was a vice president and chief underwriter at Citibank
- In 2011 she blew the whistle on her employer for fraud
- The US Government brought a lawsuit against Citibank, which was settled for \$158.3 million
- Hunt received \$31 Million

(<http://www.whistleblowerrecovery.com/citibank.html>)



# **Socially Responsible Investing**



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# Socially Responsible Investing



- “The act of investing money with the deliberate intention of achieving both financial value (return on capital) and social value (positive impact on social and environmental problems).” (Duke University CASE i3)
- Other terms used: Sustainable and responsible investing, ethical investing
- Related terms: impact investing (focuses on investment in privately owned entities and non-profits by individuals, governments and foundations)

# The Promise



“Who says you can't invest responsibly and still beat the S&P 500? Now You Don't Have To Choose Between Your Financial Goals And Our Planet's Future – The myth about environmentally and socially responsible investing is that as an investor, you have to give something up—investment quality, portfolio diversification, or fund performance. At Sierra Club Mutual Funds, we beg to differ. While you do your part to protect the planet for your children and for future generations, we do ours by seeking attractive investment opportunities in well-known companies that meet strict Sierra Club social and environmental guidelines.” (Advertisement)

# US SRI Trends



**Fig. A: Sustainable and Responsible Investing in the United States 1995–2012**

	1995	1997	1999	2001	2003	2005	2007	2010	2012
ESG Incorporation	\$166	\$533	\$1,502	\$2,018	\$2,157	\$1,704	\$2,123	\$2,554	\$3,314
Shareholder Resolutions	\$473	\$736	\$922	\$897	\$448	\$703	\$739	\$1,497	\$1,536
Overlapping Strategies	N/A	(\$84)	(\$265)	(\$592)	(\$441)	(\$117)	(\$151)	(\$981)	(\$1,106)
<b>TOTAL</b>	<b>\$639</b>	<b>\$1,185</b>	<b>\$2,159</b>	<b>\$2,323</b>	<b>\$2,164</b>	<b>\$2,290</b>	<b>\$2,711</b>	<b>\$3,069</b>	<b>\$3,744</b>

SOURCE: US SIF Foundation.

NOTE: Overlapping assets involved in some combination of ESG incorporation (including community investing) and shareholder advocacy are subtracted to avoid potential effects of double counting. Separate tracking of the overlapping strategies only began in 1997, so there is no datum for 1995. Prior to 2010, assets subject to ESG incorporation were limited to socially and environmentally screened assets.

- December 2011: \$3.31 trillion in US-domiciled assets
- Approximately 1 in every 9 dollars invested
- 30% increase since December 2009



# UK SRI Trends



- June 2013: £12.2 billion
- 11.7% growth since Dec 2011

(<http://www.eiris.org/>)

# Investment Decisions



- Generally involves applying environmental, social and governance (ESG) criteria to investment analysis and portfolio selection
- Five principle methods, which can be combined:

- **Positive screening:** Seeking out companies, sectors, or projects with identifiable positive ESG impacts, product lines or commitments, such as clean technology or renewable energy solutions, or projects that revitalize urban neighborhoods.
- **Full ESG integration:** Explicit inclusion of ESG risks and opportunities into all processes of investment analysis and management.
- **“Best-of-class” approach:** Selecting companies with the best performance within a particular sector or industry group.
- **Thematic investing:** Targeting specific themes such as climate change or human rights.
- **Avoidance or Exclusionary screening:** Avoiding or divesting from poor performers regarding ESG factors.

# SRI Products and Services



- **Indices:** Dow Jones Sustainability Indices (DJSI), FTSE4Good
- **Mutual Funds:** Calvert, Pax
- **Rating and screening:** MSCI KLD (Morgan Stanley), ASSET4 (Thomson Reuters),
- **Performance:** Studies show a variety of outcomes. Many funds' performance matches S&P 500

# Dow Jones Sustainability Index



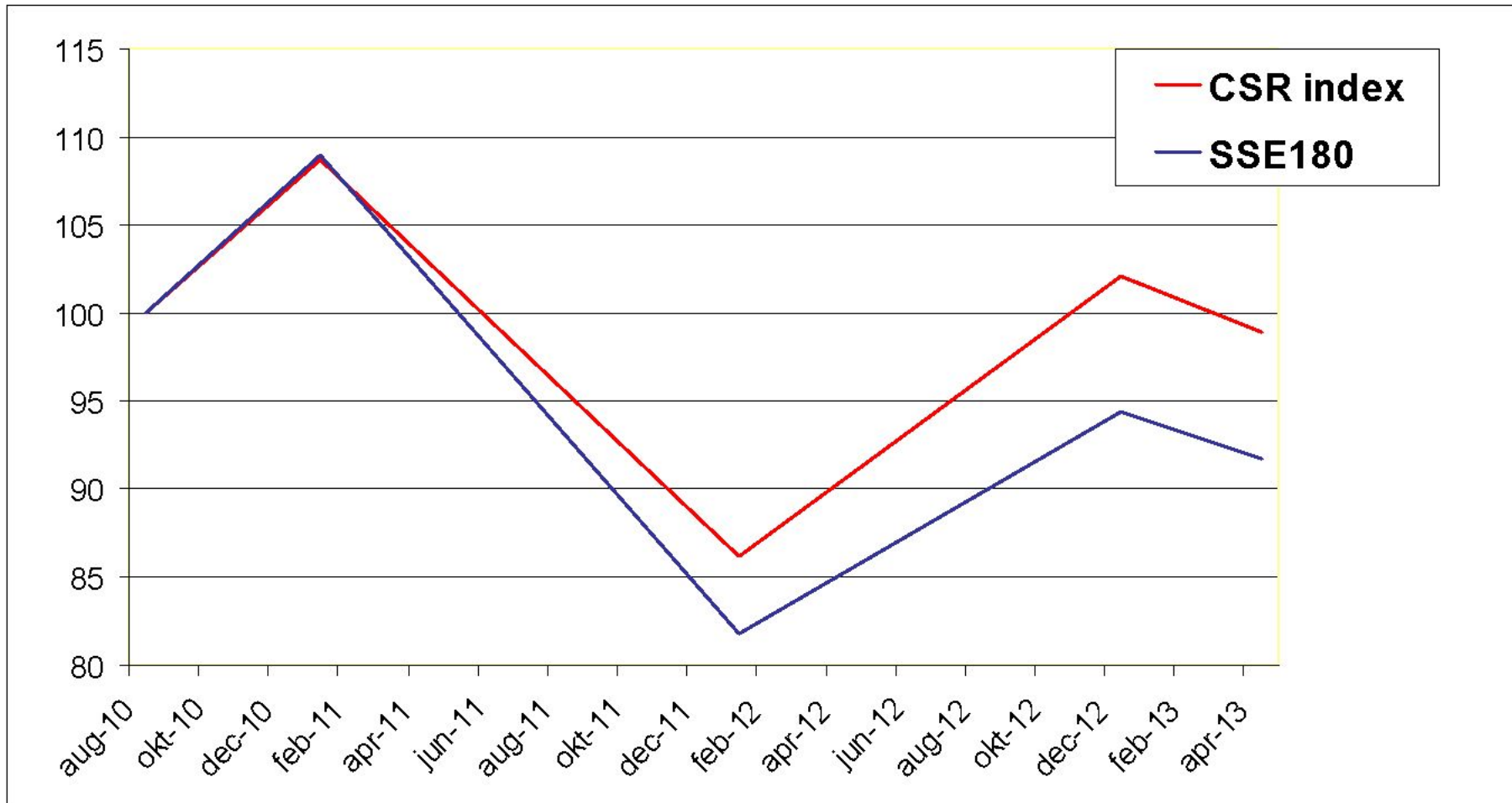
- 'Best-in-class' approach
- Companies accepted into index chosen along following criteria:
  - Environmental (ecological) sustainability
  - Economic sustainability
  - Social sustainability
- Criticisms of index:
  - Depends on data provided by the corporation itself
  - Questionable criteria used by index
  - Focuses on management processes rather than on the actual impact of the company or its products

# Shanghai Stock Exchange



- Introduced CSR Index in August 2010
- 100 firms with highest ESG rankings
- What was the performance of the CSR Index relative to the SSE180?

# SSE CSR Index Performance



5 August 2010 = 100

# Top 10 stocks held in SRI funds in emerging market firms, 2012

Position	Company	Industry
1.	Samsung Electronics ( <i>South Korea</i> )	Electronics
2.	Taiwan Semiconductor ( <i>Taiwan</i> )	Electronics
3.	China Mobile ( <i>China</i> )	Telecommunications
4.	ICBC ( <i>China</i> )	Financial services
5.	America Movil ( <i>Mexico</i> )	Telecommunications
6.	Petrobras ( <i>Brazil</i> )	Oil and gas
7.	Gazprom ( <i>Russia</i> )	Oil and gas
8.	CNOOC ( <i>China</i> )	Oil and gas
9.	China Construction Bank ( <i>China</i> )	Financial services
10.	Vale Do Rio Doce ( <i>Brazil</i> )	Mining

Source: Eiris, 2012

# Criticisms of SRI



- Quality of information
- Dubious criteria
- Too inclusive
- Strong emphasis on returns



# Principles of Responsible Investing



- Developed by the United Nations
- One of several frameworks that propose to integrate ESG criteria into investment decisions

# Principles of Responsible Investing



1. We will incorporate ESG issues into investment analysis and decision-making processes.
2. We will be active owners and incorporate ESG issues into our ownership policies and practices.
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.
4. We will promote acceptance and implementation of the Principles within the investment industry.
5. We will work together to enhance our effectiveness in implementing the Principles.
6. We will each report on our activities and progress towards implementing the Principles.

# Islamic Finance



- Based on the ethical principles of Islam
- Rapidly growing industry
- The stated primary objectives are:
  - Equal distribution of wealth
  - Social justice
- Similarities to traditional finance:  
The aims are successful financial intermediation and making a profit

# Islamic Finance



Key differences:

- Interest prohibited
- No financing of “sinful” activities such as alcohol, gambling and pornography
- Requirement for profit, equity and risk sharing
- Prohibition on speculation
- Financial products must be backed by tangible assets

	<b>Islamic Banking</b>	<b>Conventional Banking</b>
<b>Regulations</b>	Functions and operations are based on Sharia'h principles	Functions and operations are based on fully man made principles
<b>Profit</b>	Aim at maximising profit but subject to Sharia'h restrictions	Aim at maximising profit without any restrictions
<b>Risk</b>	Promote risk-sharing between provider of capital (investor) and user of funds (entrepreneurs)	Investor is assured of pre-determined rate of interest
<b>Risk vs. Profit</b>	No right of profit if there is no risk involved. The profit and loss sharing: depositor may lose money in case of a loss	“Negative profit” not possible because interest is guaranteed
<b>Relationship between contract parties</b>	Partners, investor and traders, buyer or seller relationship	Creditor-Debtor relationship
<b>Subject of contract/ financing</b>	Encourage asset-based financing and based on commodity trading. Money is solely a medium of exchange and not a commodity, its sale and purchase is prohibited in Islam	Based on money trading Anything can be financed Speculation



# Shareholder Activism



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# Shareholder Activism



- Shareholder attempts to exert greater control over corporate decision making and actions by exercising their legal rights

Two routes, often combined:

## 1. Shareholder proposals

- In the US, can be introduced by any shareholder who held over \$2000 in shares during the preceding year
- Added to the corporate proxy statement and voted on by all shareholders
- Often non-binding but disregard can be problematic for management

## 2. Speaking out at the annual shareholder meeting

# Shareholder Activism Examples



JP Morgan 2012 Proxy Statement contained 7 shareholder proposals:

- **Proposal 4 – Political non-partisanship.** Famous activist Evelyn Y. Davis asked for political neutrality to avoid entanglements with certain political parties which could become detrimental to its business.
- **Proposal 5 – Independent director as chairman.** Federal and State employees organization AFSCME Pension Plan addressed the fact that CEO James Dimon also serves as chairman of the Company's board of directors. This combination of roles has the possibility of harming a corporation's governance policies.
- **Proposal 6 – Loan servicing.** The Board of Pensions of the Presbyterian Church requested the Board of Directors to oversee development and enforcement of policies to ensure that loans that are in default or foreseeable default are adequately modified. In other words, it asked JP Morgan to make an attempt to help those that have defaulted due to their own poor lending practices.
- **Proposal 8 – Genocide-free investing.** Mr. William L. Rosenfeld asked the company to avoid investments in companies who are connected to genocide.



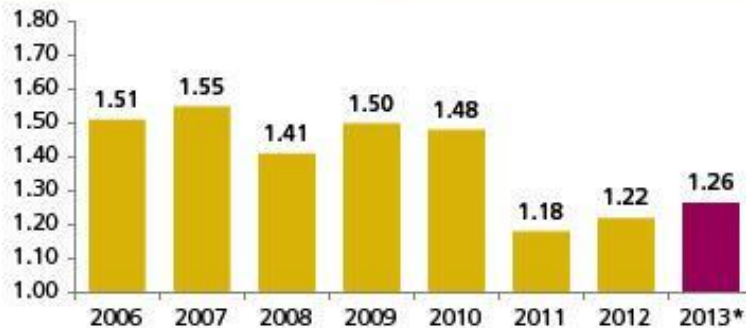
# Shareholder Activism Examples



- McDonald's 2013 Proxy Statement contained a shareholder proposal that sought to prevent the company from marketing its fast food products to children given the serious impact that fast food has on public health.
- Such resolutions typically garner 6-8% of votes

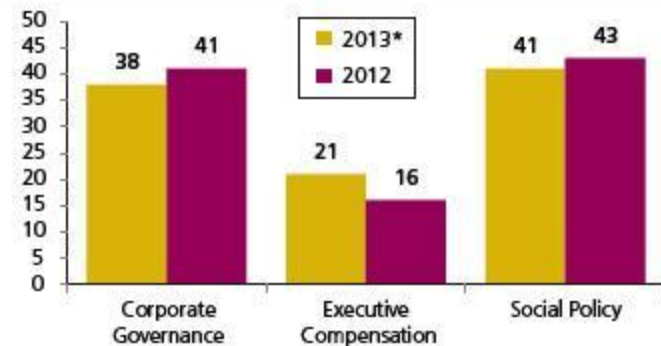
# Shareholder Activism Trends

Shareholder Proposals per Company,  
Fortune 250, 2006–13



\*Based on 220 of 250 companies filing 2013 proxy statements by mid-August

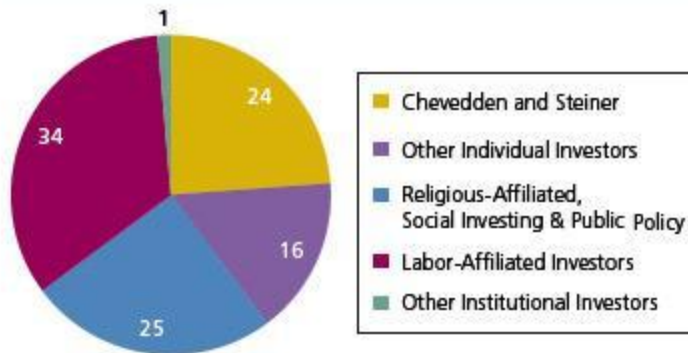
Percentage of Shareholder Proposals Introduced  
by Proposal Type, Fortune 250, 2012–13



\*Based on 220 of 250 companies filing 2013 proxy statements by mid-August

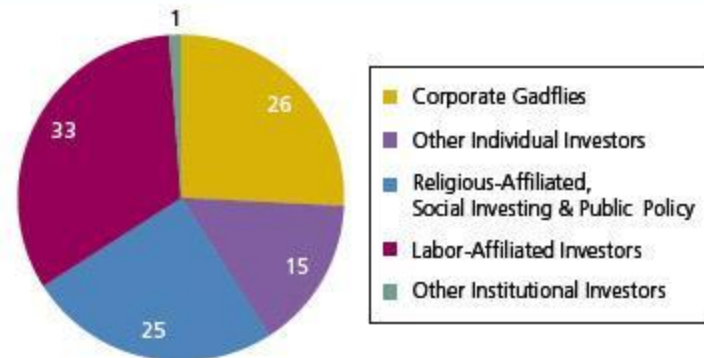
# Shareholder Activism Trends

Percentage of Shareholder Proposals by Proponent Type, Fortune 250, 2013\*



\*Based on 220 of 250 companies filing 2013 proxy statements by mid-August

Percentage of Shareholder Proposals by Proponent Type, Fortune 250, 2006-13\*



\*Based on 220 of 250 companies filing 2013 proxy statements by mid-August

- Only 7 percent of shareholder proposals received the backing of a majority of shareholders in 2013, down from 9 percent in 2012

# Shareholder Activism Impact



- *“An analysis of around 2,000 interventions in America during 1994-2007 found not only that the share prices and operating performance of the firms involved improved over the five years after the intervention, but also that the improvement was greatest towards the end of the five-year period. The firms activists targeted tended to be underperforming relative to their industry. These results hold true for the two sorts of activism that tend to be criticised most: actions designed to increase a firm’s leverage, such as taking on more debt or using cash to buy back shares, and actions that are especially hostile to a firm’s current management.” (Economist, 2014)*
- Sends signals to management, even if it doesn’t pass

# Conclusion



- Divergent interests between shareholders and managers and information asymmetry can create ethical problems that hurt shareholder value.
- We assume that shareholders only want financial return, but the emergence of shareholder activism and SRI show that a growing number of shareholders are concerned with ethics and governance issues.
- SRI is growing and slowly becoming mainstream. These are helping to make firms aware of ethical issues and CSR.
- Islamic finance is another growing phenomenon indicating that many investors are concerned with more than only profits.

# Next Lecture



- Dr. Oliver Laasch
- Stakeholder analysis and engagement
- CSR & sustainability standards, tools and reporting
- Read textbook chapter 5, pp. 177-195
- Other readings will be posted on Moodle

**THANK YOU**