

# **The Misallocation of Capital: Using Benefit Corporation Governance to Align Our Investments With Our Needs**

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# Capitalism

**Financial capital is the fuel that allows the private economy to provide the goods and services we rely upon.**

# **Corporations Pool Capital**

**The corporation is a marvelous piece of financial technology that allows disparate investors to pool their financial capital and diversify their risk.**

# History of the Corporation

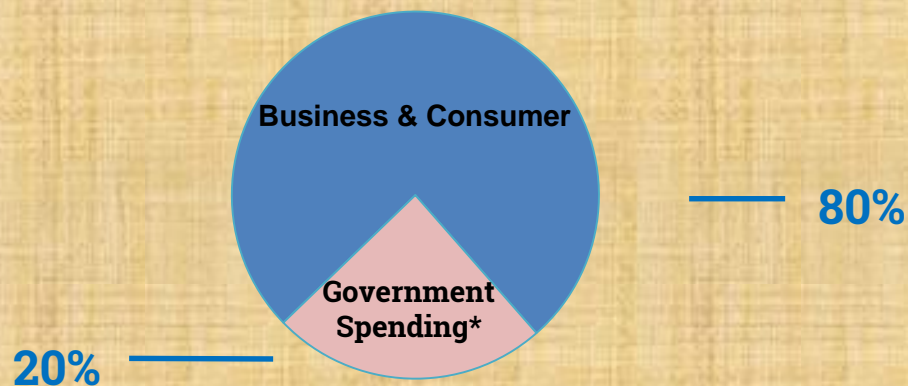
- **Royal charters: trading companies**
- **Legislative charters; infrastructure: bridges, canals, railroads**
- **Limited purpose, free incorporation: manufacturers**
- **General incorporation: all business**

**Note the move from public purposes to “business is good.”**

# Where is the Capital?

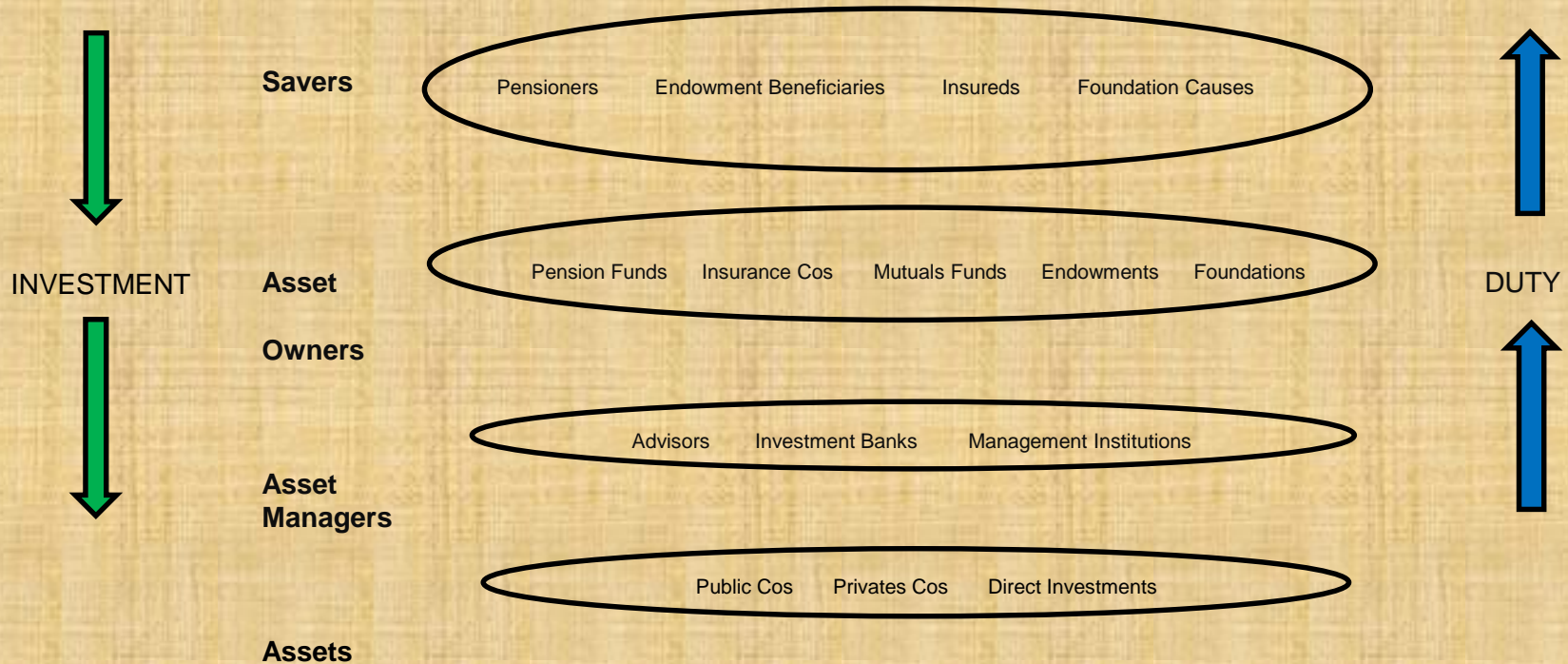
\$350T	-	VOE
\$100T	-	Debt
\$70T	-	Public Equity
\$10T	-	PE & VC

# Who Allocates Capital?



\* Excluding transfer payments

# Investment Channel



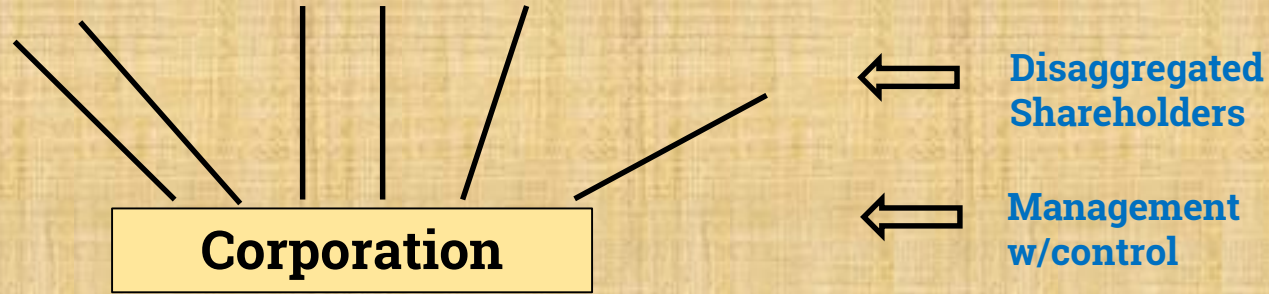


# **Purpose of Financial Industry**

- **Protect and grow savings and allow transfers to future self and later generations**
- **Direct savings to capital projects**
- **Steward that capital**



# Agency Problem in the Industrial Corporate Economy: Beyond the Pin Factory



**Concern: agent management will usurp shareholder capital.**

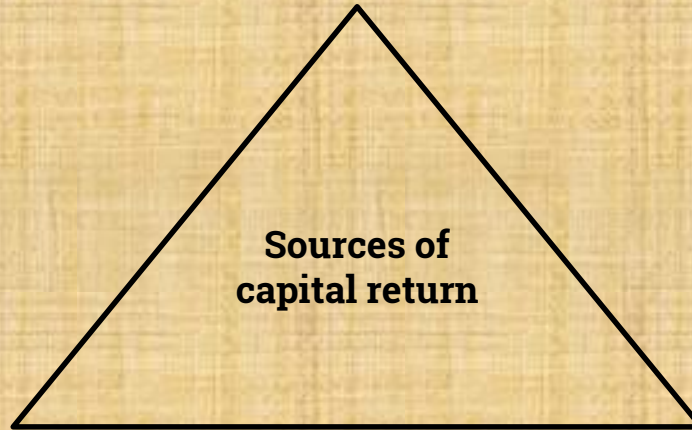
# Shareholder Primacy Solution Syllogism

1. Management must act for benefit of shareholders
2. Shareholders are only interested in financial return on investment
3. Therefore, director duty is to increase return on stock

**Financial capital is indifferent to strategy, as long as return on investment is maximized**

# Investment Capital Deployed to Yield Return

**Value creation & sharing: positive sum (reduction in energy use)**



**Exploiting externalities: negative sum strategy (carbon emission w/o factoring in cost)**

**“Phishing”: zero sum strategy (high pressure sales tactics)**

# Primacy Trap

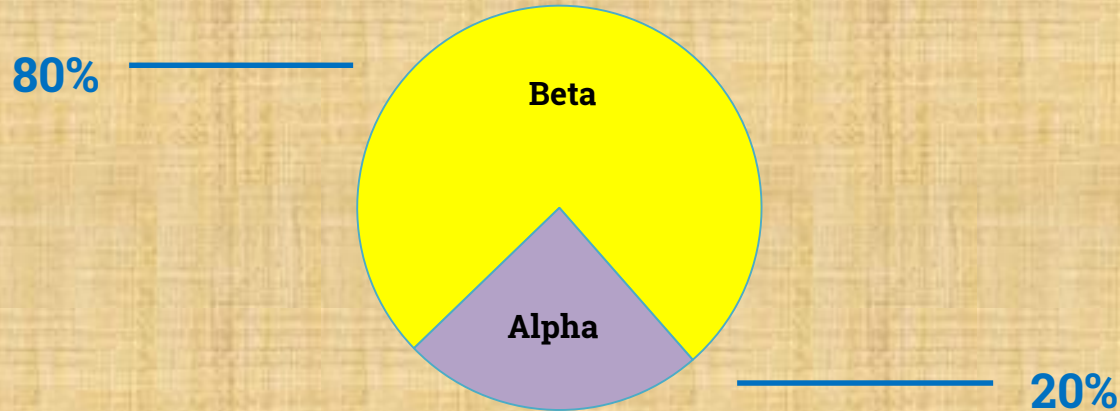
**Negative sum strategy satisfies up-the-channel duty, creating incentive for capital to be allocated to create net negative effects.**

**Modern Portfolio Theory amplifies the effect by emphasizing importance of alpha and tracking error**

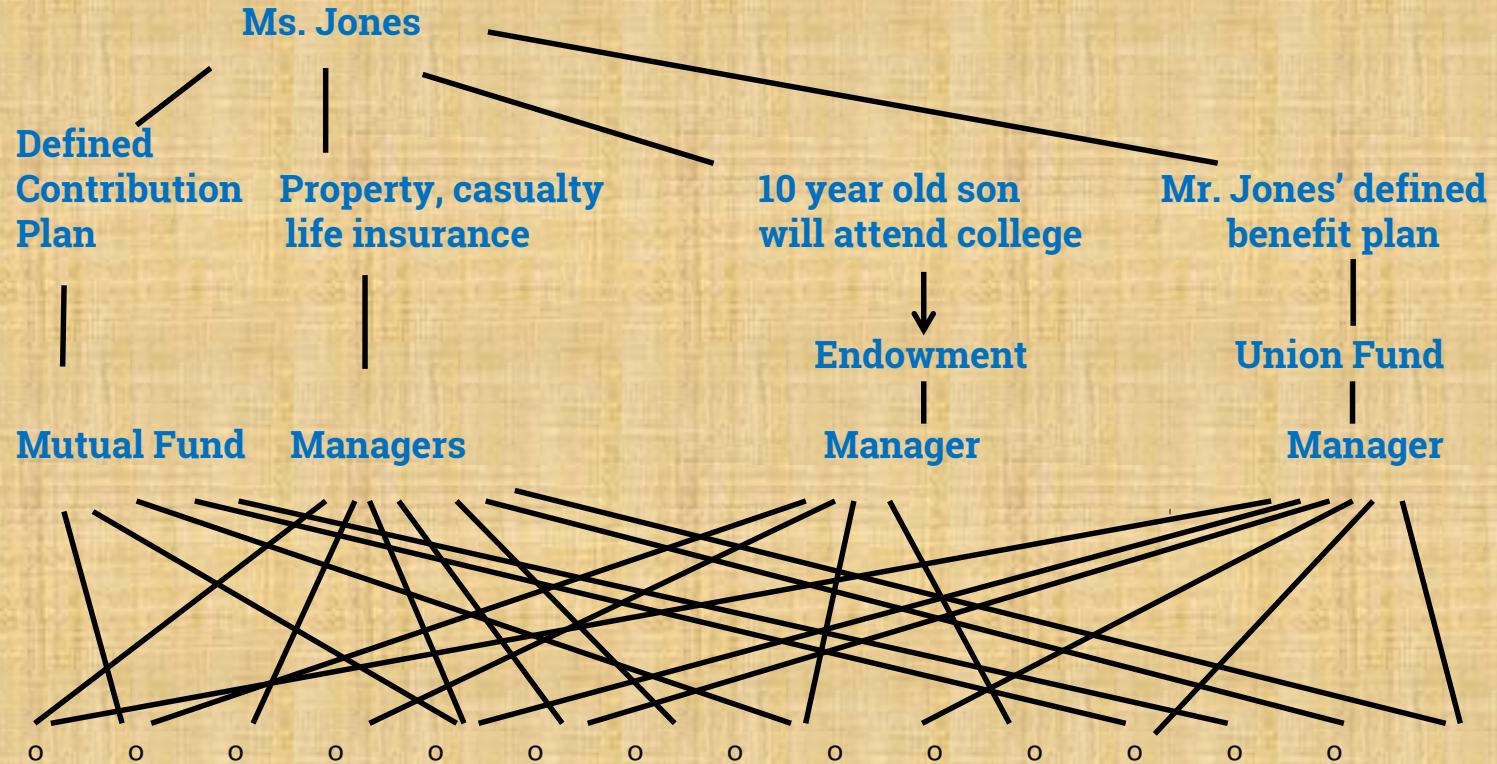
- **Managers seek to “beat the market”**
- **Managers treat market performance as exogenous**

**BUT . . .**

**Source of Returns is the Market**



# Investment Web



# Modern Portfolio Theory Is Wrong

- Investor activity, both capital allocation and investment stewardship, determines market performance.
- Investor focus on individual company performance alone inevitably leads to systemic damage.



# **What Investors Really Need**

**In order to benefit from their investments over the long term, citizen shareholders need responsible corporate citizens, pursuing sustainable, long-term strategies.**

# Market Failure

***The primary failure of capital markets in relation to sustainable development is one of misallocation of capital. This, in turn, is a result of global governments' failure to embed environmental and social costs into companies' profit and loss statements. As a consequence, capital markets do not incorporate companies' full social and environmental costs. The consequences of this are that unsustainable companies have a lower cost of capital than they should and so are more likely to be financed than sustainable companies.***

# **Benefit Corporation Governance Can Change the Paradigm**

**Benefit corporation governance allows  
corporations to adhere to authentic  
sustainability principles.**

# Three Key Elements of Benefit Corporation

**Benefit corporation governance is a legal tool that helps for-profit companies create positive impact on society and the environment. It aligns investors, boards, shareholders and stakeholders around a shared objective: creating durable and shared long-term value.**

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## Expanded Purpose

Beyond maximizing share value to explicitly include general public benefit

## Accountability

Directors are accountable to balance stockholder and stakeholder interests when making decisions

## Transparency

The legislation requires transparency to your shareholders with respect to the expanded purposes.

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# **Current Law and Markets Erode Purpose and Sustainability in For- Profit Companies**

## **Under Current Practice:**

- **The ultimate goal of directors is to create and maximize share value.**
- **Value maximization is focus in exit transactions.**
- **Business strategies that require authentic commitment to stakeholders may be compromised.**

# **Benefit Corporation Law Provides Tools to Protect A Sustainable Vision**

## **Benefit Corporation Status Expands:**

- **Corporate Purpose**
- **Business Judgment Rule**
- **Liability Protection for Directors**
- **Flexibility in Change in Control Situations**



# Benefit Corporation Governance Allows Corporations to Fully Integrate Sustainability Into Operation

- Many companies thrive by integrating sustainability into operations
- Under conventional corporate governance, sustainable performance is always contingent on narrow conception of fiduciary duty
- Benefit corporation governance allows full integration by committing to future sustainable performance
- This full integration permits the creation of durable wealth within stable systems
- **Creates benefits across portfolio and systems for universal owners**



# Benefit corporation status can be used to preserve long-term perspective in the public markets

- Public companies are subject to short-term pressures not experienced by private companies (Etsy, Whole Foods and Unilever).
- Many advisers will recommend classified boards and dual class stock as ways to address these pressures. These structures are controversial, and can draw activist attention.
- Benefit corporation governance is a way to address this issue directly, without affecting shareholder rights. May attract shareholders with a longer term perspective, and provide management with credibility to make long term choices.

# **Now Is The Time: Institutions' New Power**

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**Boards declassified**

**Majority voting**

**Proxy access**

**Proxy contests**

**Say on pay**

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# How Is Power Being Used?

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**Board diversity, independence**

**Shareholder rights**

**Pay for performance**

**Environmental/Social?**

**Long-termism?**

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# Opportunity

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Long term, universal investors have more power than ever before. Their return is based 80%+ on the return of the market, and their beneficiaries are just plain folks who need a thriving economy and healthy planet.

Contemporary corporate governance developments represent our best chance to deliver the message that the interests of the citizen shareholders who own the market is best served by corporations that maximize value across human, natural and social capital, as well as financial capital. Benefit corporation governance is the best way to implement this critical change.

# Evolving Investment Standards Point in This Direction

*ICGN encourages companies, boards and investors to think and act systemically with regard to preserving the integrity and stability of financial markets as a whole. --ICGN*

*... the Fund's large size and broad holdings mean that direct and indirect exposure to market-level risks is inevitable. The fund is also mindful that when market level efforts create a rising tide that lifts all boats, the Fund is among those who will benefit most.*

-- NY Common Fund

*As one of the largest asset managers in the world, we have an important responsibility to the millions of individuals who entrust their financial futures to us through retirement plans, endowments and foundations, financial intermediaries, and sovereign institutions. Our mission is to invest responsibly on their behalf to enable economic prosperity and social progress over the long term.*

-- Ron O'Hanley, Chairman of State Street

Investment practices that foster intergenerational transfers of risk and wealth raise duty of impartiality concerns for long-term investors. Changes in understanding of *systemic risk*, and related investment management practices among global peers, demonstrate an ongoing evolution in the *prudence standards* against which the conduct of fiduciaries is judged.

-- BlackRock/Ceres 21st Century Engagement

# Shareholder Protections

Protection	Type	Conventional Corporation	Benefit Corporation
Elect Directors	Governance	✓	✓
Transaction Votes	Governance	✓	✓
Mission Alteration High Vote	Governance		✓
Duty of Care	Fiduciary Duty	✓	✓
Duty of Loyalty	Fiduciary Duty	✓	✓
Duty of Disclosure	Fiduciary Duty	✓	✓
Derivative Suits	Enforcement Mechanism	✓	✓
Director/Class Action	Enforcement Mechanism	✓	✓
Books & Records Action	Enforcement Mechanism	✓	✓
Election Review	Enforcement Mechanism	✓	✓
Heightened Scrutiny	Standard of Review	✓	✓
Entire Fairness	Standard of Review	✓	✓
Benefit Report	Disclosure Right		✓



# Director Protections

Protection	Conventional Corporation	Benefit Corporation
Business Judgment Rule	✓	Expanded to include decisions made to benefit stakeholders
Indemnification	✓	✓
Insurance	✓	✓
Exculpation	✓	Expanded to include any balancing decision among stakeholders, including shareholders
Legal permission to consider stakeholder interests in sale process		✓
Legal permission to consider stakeholder interests in defensive situations (hostile takeovers)		✓



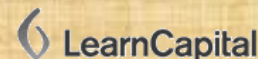
# Venture Capital Case Studies



**Total raised = \$32.7 Million**



**Total raised = \$173 Million**



# Natura Public Conversion Case Study



# **Public Company Subsidiaries**

**Plum Organics (Campbell's)**

**DanoneWave (Danone)**

**Happy Family (Procter & Gamble)**

**Lung Biotech (United Therapeutics)**

# Case Study: Laureate Education IPO

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## Sponsor

Private equity backed

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## Bankers

Credit Suisse; Morgan Stanley;  
Barclays; J.P. Morgan;  
Macquarie, BMO Capital  
Markets; Citigroup; Goldman  
Sachs & Co.

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## Lawyers

DLA Piper / Simpson Thacher

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## Profile

\$4.2 billion 2016 revenue

70 campuses/online schools

Operations in 25 countries

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## Funding

Pre-IPO round: \$400 million

IPO: Raised \$490M; priced on  
February 1, 2017

