New Models of 'Intelligent Investing' for the Post-Crisis Economy

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Keywords: blockchain, coronavirus, corporate governance, corporations, entrepreneurship, high-frequency trading, innovation, investors, liquidity, private companies, smart contracts, stock markets

JEL Classifications: D21, D26, G32, G34, G38, K22, L21, O16

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Mark Fenwick[1] *and Erik P.M. Vermeulen*[2]

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The financially driven corporate world has been losing its appeal over recent years and an anti-corporate sentiment has become more prevalent. There is a greater demand for better standards of corporate behavior and new metrics for judging corporate success. What is ironic is that corporations that embrace a more stakeholder-oriented purpose already outperform their peers when it comes to stock market returns. When thinking about re-building the economy post-crisis, this paper argues that investors need to be encouraged to take 'intelligent risks' that focus on stakeholder-oriented listed and non-listed companies.

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1. Introduction

Economies are in freefall. People are losing their jobs. Companies, large and small, are going out of business. Pension funds are taking a big hit. Consumer confidence is disappearing. As the coronavirus affects more and more sectors of the economy, the obvious questions to ask are: What will the world look like after the crisis? Will we ever get 'back to normal,' or will the post-crisis economy be very different? Are we facing a new reality, and – if so – what kind of economy do we want it to be?

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For sure, nothing is certain. The only thing we do know is that with every extension of the lockdown, the calls for short-term rescue and financial stimulus get louder. Economic plans need to focus on saving small and medium-sized enterprises and protecting low-income and middle-class families and other persons without a financial cushion. Of course, health is the priority. But it would be a mistake not to consider the longer-term economic aftermath and visions of how we might do things 'better' next time.

One of the major issues that we will face is the issue of 're-risking' the economy post-crisis. Governments will need to encourage people to take new risks. Think about it. Over the last few decades, economic growth has been driven, in large part, by the innovators who 'think different' and take a chance to launch a new business, take a job in a young business, or invest in a growing business. Economic risk-taking is a virtue that has fed disruptive technological innovation and changed the world.[3] Such risk-taking needs to be appreciated and encouraged. The fear is that recent events will have a chilling effect on people's willingness to be entrepreneurial in their life choices. This could prove a damaging economic legacy of a public health crisis.

Unlike the wars or natural disasters of the past, it will not be obvious when this crisis is 'over.' The post-1945 economic boom – the 'golden age' of capitalism – was kickstarted, in part, by a sense of optimism and hope that the upheaval was over and the task of building a new world could begin.[4] Hope provided the impetus and energy for this massive undertaking. A similar sense of hope seems hard to imagine right now. Any illusions that things will immediately go back to normal quickly have disappeared as our political leaders, and their scientific advisors warn us that some form of social distancing is here for a long time. We will soon move into a messy and protracted transitional phase – a state of limbo – between emergency and normality.

Under such conditions, it is going to be challenging to get people to start re-taking business risks. Here, we consider this issue of 're-risking' the economy by focusing on investments in businesses and what might be done by regulators and other market actors to encourage investment after the initial medical crisis has been overcome. We advocate what we call 'intelligent investing' – risky, but smart investments in firms that take a more socially responsible view of the purpose of business – as one possible future direction.

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[3] See, for example, Atkinson, Robert D., and Ezell, Stephen J. 2012. *Innovation Economics*. New Haven: Yale University Press.

[4] See Levinson, Marc. 2016. *An Extraordinary Time*. New York: Basic Books.

The argument proceeds as follows. In Section 2, in order to provide some context, we describe how, over the last few decades, management of and investment in joint-stock corporations has become financially-oriented – so-called shareholder primacy. This is the view that the sole purpose of a corporation is to maximize the return for investor-shareholders. As an example, we describe how public markets are dominated by sophisticated institutional investors engaging in algorithm-driven, high-frequency trading.

In recent years, however, this financial model of the corporation and investment has been heavily criticized, and we have seen the emergence of new demands for more responsible forms of corporate behavior and investment.

The remainder of the paper, therefore, focuses on developing two alternative models that might provide the basis for a different 'post-crisis' economy. We present these as examples of 'intelligent investing,' and everyone needs to think about how these forms of smart, socially responsible risk-taking might be encouraged and fostered.

Section 3 considers the stakeholder model of the corporation. On this account, companies should not focus exclusively on the interests of shareholders. Instead, corporations must deliver value to their customers, build the capacities of their employees, deal fairly with suppliers and other business partners, support local communities in which they work, and protect the environment. We present evidence that corporations adopting a more stakeholder-oriented approach deliver strong financial performance, as well. Investors need to be encouraged to take intelligent risks that focus on stakeholder-oriented companies.

Section 4 describes a second model of intelligent investing focused on private markets. Investing in younger startup and scale-up companies can also prove lucrative. Here, we are talking about investments in non-listed companies in private markets. Many such companies also adopt a more stakeholder-oriented approach in that they aren't yet profitable but may deliver significant financial returns and social value in the future.

Traditionally, this asset class is only available to a relatively narrow class of wealthy, 'accredited' investors. We argue that this type of investment should be opened to other people, particularly in times of crisis. Even if the stock market rebounds, investing in listed companies will only help institutional investors and the wealthy. It will not be enough for the lower and middle class. We briefly describe how technology – in the form of blockchain and smart contracts – might provide some level of protection and make private markets more accessible to the lower and middle class.

Post-crisis re-building will be challenging. SMEs, in particular, face profit shortfalls and will need liquidity. But this situation also presents an opportunity to push for new corporate and investment models. The two examples shown here could help 're-risk' the economy and have the additional effect of moving us towards more sustainable and democratic forms of capitalism.

2. The Purpose of the Corporation? *'It's All About the Money . . . Right?'*

What are the greatest inventions of the past 2,000 years?

If you invite people to submit a list of the most influential inventions in human history, the answers will vary greatly. There are so many impressive achievements that helped the world move forward. Paper. Fertilizer. Printing presses. Electricity. The automobile. Airplanes. The telephone. The microprocessor. The Internet. The list of potential candidates is long. Technological innovation is amongst humanity's greatest achievements. And, no doubt, a person's choices will reflect their interests and perspective. Most of the above-listed inventions were genuinely disruptive. They improved the quality of people's lives immeasurably, created fantastic new opportunities, and opened new markets.

But how many people would mention the corporation? Our guess. Not that many. At first sight, an imaginary 'legal' person doesn't measure up to other life-changing inventions of the past. And yet, don't dismiss the corporation too quickly. Israeli historian Yuval Noah Harari (author of the non-fiction bestsellers 'Sapiens' and 'Homo Deus') places the 'legal fiction' of the corporation or 'imagined reality' among humanity's most ingenious inventions.[5] Others have made similar claims.[6] Think about it. Corporations have provided the basis for sustained economic growth and prosperity and have played a vital role in developing and disseminating new technologies and improving the standard of living and quality of life for vast numbers of people.

[5] Harari, Yuval Noah. 2014. *Sapiens: A Brief History of Humankind*. New York: Harper. Chapter 16.

[6] See Bakan, Joel. 2001. *The Corporation.* New York: Free Press; Micklethwait, John, and Wooldridge, Adrian. 2005. *The Company: A Short History of a Revolutionary Idea*. London: Weidenfeld.

All it takes is an ‘imaginary’ legal person that exists independent from its founders, investors, and managers. The corporation allows investors to exit and trade their shares without dissolving the business. And if the CEO leaves (for whatever reason), the corporation continues to exist as well.

Modern corporations have become the leading players in the economy. They have encouraged entrepreneurship and economic risk-taking for over two centuries. The corporation has proven an extremely effective way to enable the aggregation of capital for productive purposes. You see them everywhere, in many forms, operating alone and in groups. Startups. Joint ventures. Multinationals. Conglomerates. Some of them are extremely powerful and richer than entire countries.

Of course, corporations have not been an unconditional good. They are ambiguous, messy things. Besides the success stories, the ‘imagined reality’ of the corporation has caused severe problems since its inception. Corruption. Fraud. Greed. Unethical or overly risky behavior. A corporation offers the opportunity for people to hide behind and misappropriate its corporate veil at the detriment of usually weaker parties and society as a whole. Moreover, corporations have contributed to many of the most pressing problems that humanity has encountered over the last two centuries: pollution and climate change, recessions and depressions, and staggering levels of economic inequality.

Perhaps, it is this mixed history that explains the exclusion of the corporation from the list of ‘greatest inventions.’ It certainly explains the ambivalent feelings that many people have towards corporations and the corporate world. Mistrust of the corporate world - an anti-corporate mood – has become a defining feature of our societies, culture, and politics.[7]

And whenever there is a crisis in the corporate world or the economy more generally, the same questions continue to pop up: What – or Who – is a corporation for? Is the purpose of a corporation simply to make money? Or do they have a broader role in society? Do corporations also have a social responsibility to help improve the world?

Since the 1980s, there has been a broad consensus on these questions. The primary goal of a corporation is to make a profit for investor-shareholders – so-called ‘shareholder primacy.’ Nobel-prize winning US economist Milton Friedman famously took this view. An often-quoted line from

[7] Cohen, Roger. 2016. ‘Age of Distrust.’ *New York Times*. September 19, 2016. Available at https://www.nytimes.com/2016/09/20/opinion/the-age-of-distrust.html.

his 1970 article in the New York Times Magazine expresses the underlying thought: 'There is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits.'[8]

To be sure, other views about the purpose of the corporation have been voiced across the developed - and to a lesser extent - the developing world over the past years.[9] A recent example is the Business Roundtable, an association of chief executive officers of leading companies in the United States. On August 19, 2019, the association clearly stated that 'CEOs endeavor every day to create value for all our stakeholders, whose long-term interests are inseparable.'[10] The emphasis on '*all* our stakeholders' is significant. It reflects the view that companies are not static hierarchical organizations focused on the 'primacy' of shareholders.

However, empirical research indicates that the companies associated to the Business Roundtable have not amended their ways of working.[11] It appears that the financial model of the corporation as a shareholder-oriented organization remains hugely influential, leading most companies to continue to focus on shareholder value and short-term (quarterly) financial performance.

This approach could of course change when the shareholders/investors start demanding companies to serve other stakeholders, customers, employees, and society, as well. At first sight, it appears that shareholders increasingly take criteria based on environmental, social, and governance (ESG) into account when making investment decisions. However, the data does not give a clear-cut answer yet. At the end of the day, the ESG footprint is less important than the financial performance and its impact on stock price of a company.[12]

As such, the dominant view is to remain focused on the money. And investors have increasingly automated investment decisions to decrease transaction costs, minimize human error, and boost

[8] Friedman, Milton. 1970. 'The Social Responsibility of Business.' *New York Times Magazine*. September 13, 1970. P. 2.

[9] A. Kole Amico, 'The Pandemic is the Litmus Test of Stakeholderism', *Harvard Law School Forum on Corporate Governance*, 2020. Available at: https://corpgov.law.harvard.edu/2020/05/04/the-pandemic-is-the-litmus-test-of-stakeholderism/.

[10] Business Roundtable, 'Statement on the Purpose of the Corporation', 2019. Available at: https://opportunity.businessroundtable.org/wp-content/uploads/2019/12/BRT-Statement-on-the-Purpose-of-a-Corporation-with-Signatures.pdf.

[11] L.A. Bebchuck, & R. Tallarita, 'The Illusory Promise of Stakeholder Governance', *Working Paper* 2020.

[12] B. Cornell and A. Damodaran, 'Valuing ESG: Doing Good or Sounding Good?', *Working Paper* 2020.

trading efficiency. Institutional investors and investment banks are increasingly becoming technology companies,[13] casting at least some doubt on the sustainability of the ESG bandwagon.

High-frequency traders are a good example.[14] Even though they only count for a small part of all traders out there, they are responsible for two-thirds of all stock market transactions. They use super-fast computers and custom-built high-frequency trading algorithms to take advantage of movements in the market. The increased uncertainty and volatility in stock markets during the current crisis make high-frequency trading very lucrative. Where many institutions are losing big-time, high-frequency traders are benefiting hugely from the disaster.

This may not be a problem in itself, but it has put them in the spotlight. Mainstream media have started to satirize high-tech frequency traders for not contributing in any way to solving the crisis.[15] The reality is quite the opposite. High-tech frequency traders attract the most talented mathematicians to help them make their computers faster, more flexible, and more independent.

The argument is that these mathematicians should contribute more to finding solutions that deal with the crisis and help mitigate the social and economic consequences. What made things worse was some of these traders had taken 'self-isolation' to the next level by requiring their employees to sleep in tents in the office. This clearly helps avoid virus transmission, but, more importantly (and this is the reason), could potentially lead to 'microsecond' improvements in the quality of the algorithms, allowing them to beat the competition and make more money.

It's fair to say that 'crises reveal.' Difficult, stressful moments expose the true colors of both individuals and organizations. And, too often, such moments reveal the worst of the corporate world and the shareholder primacy view. Technology is being used to take advantage of the crisis. And 'tech-savvy,' financially driven investors are the big financial winners.

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[13] J. D'Antona Jr., 'Money Machines: An Interview with an Anonymous Algorithmic Trader', *Traders Magazine,* 2019. Available at: https://www.tradersmagazine.com/departments/algos/money-machines-an-interview-with-an-anonymous-algorithmic-trader/.

[14] See Lewis, Michael. 2014. *The Flash Boys: A Wall Street Revolt*. New York: Norton. Lewis suggests that technological changes and unethical trading practices have transformed the U.S. stock market from the world's most public, most democratic, financial market into a 'rigged' market.

[15] See Van Arkel, Niels. 2020. 'Zondag met Lubach over flitshandelaren: "Laten we 0,00005 seconde klappen!".' *Gids.TV*. March 22, 2020. Available at https://www.gids.tv/video/190005/zondag-met-lubach-over-flitshandelaren-laten-we-0-00005-seconde-klappen.

3. 'Intelligent Investing' in Public Markets? Stakeholder Capitalism

However, it would be a mistake to judge the corporate world purely based on such 'anti-models.' Despite the digital revolution and technology/software 'eating the world,' we see evidence that corporations are becoming more human.[16] In the current crisis, some companies do take the health and welfare of stakeholders very seriously.[17] CEOs send emails, write blogs, and post videos in which they explain why flagship shops are closed (social distancing), online shops are upgraded, and top managers' salaries are cut. Also, they postpone dividend distributions and delay share buyback programs – everything to retain customers and avoid layoffs.

And there is more. Corporations and their managers have become increasingly innovative when it comes to engaging with stakeholders. They look for opportunities for their companies to improve the world. They generally focus on three areas: healthcare and the front-line responders, education, and, small businesses. They donate their products or make services available. Shoes for healthcare workers, latex gloves for responders, webcams for teachers, etc. Some companies also provide improvised products/services. Think sanitizers made by breweries, ventilators manufactured and assembled by car companies, and face masks donated by fashion and lingerie companies. Improvisation is everywhere right now.

Of course, one might ask how sincere and altruistic initiatives can be distinguished from window-dressing exercises. After all, history shows that we go back to 'business-as-usual' as soon as a crisis is over. There was a lot of shareholders-versus-stakeholders talk after the global financial crisis of 2008-9. But things soon went back to normal. For instance, CEO-Worker compensation ratios – which dropped dramatically in the aftermath of the crisis – soon began to increase, as well.[18] We have short memories, and anti-corporate feelings dissipate quickly when the economic situation improves. Much as a crisis reveals our true colors, good times also make us more

[16] This phrase was famously coined by U.S. venture capitalist Marc Andreessen. See Pepperell, Robert. 2003. *The Posthuman Condition*. Bristol: Intellect, p. 126. See Vermeulen, Erik P.M. 2018. 'New Metrics for Corporate Governance: Shifting Strategies in an Aging IPO Market.' In Gordon, Jeffrey and Ringe, Georg (eds.), *The Oxford Handbook of Corporate Law and Governance*. Oxford University Press. P. 839-866.
[17] See Kramer, Marc. 2020. 'Coronavirus is Putting Corporate Social Responsibility to the Test.' *Harvard Business Review* April 1, 2020. Available at: https://hbr.org/2020/04/coronavirus-is-putting-corporate-social-responsibility-to-the-test.
[18] Rushe, Dominic. 2019. 'Top US bosses earn 278 times more than their employees.' *The Guardian*. August 14, 2019.

forgiving and forgetful. Certainly, that seems to have been the case for previous twenty-first century economic crises – the dot.com bubble and 2008-9 financial crisis.

So, will it be different this time? There are good reasons to doubt it. For a start, many people are strongly attached to shareholder primacy. They have a hard time 'un-learning' what they have preached for so many years (the only purpose of a company is shareholder wealth maximization and the purpose of regulation is to ensure that the agents of the company always act in the best interests of the shareholders).[19] According to them, a stakeholder view is confusing. How can you serve multiple masters with different, and often conflicting interests? According to them, trying to find a balance is illusory and could even hurt the corporation (including all its stakeholders) in the future.

They seem to forget that a CEO or the investors don't solely define the corporation. A corporation isn't a single person or group. A corporation is a large team. It is a complex, evolving ecosystem of people (including employees, consumers, investors, founders of related startup companies, and other organizations) committed to working together *as a team* to reach a diverse set of different goals.

Like any team, a corporation is a multi-faceted entity that cannot be reduced to a simple formula. At least, reducing it to simple formula is both dishonest – it obscures the reality of the thing it describes – and counter-productive – in the sense, that any suggestions for improving performance are likely to miss the target. And, of course, serving multiple masters is difficult. But, embracing the messy reality of building a successful team that delivers a meaningful experience for everyone is undoubtedly a better, more human option than the pursuit of financial gain. Just to be clear, stakeholder capitalism isn't equal to corporate social responsibility.[20] It's a necessary strategy to ensure that corporations remain relevant in a fast-changing world.

Somewhat ironically, corporations that that seem to embrace a stakeholder-oriented purpose outperform their peers when it comes to stock market returns. Consider the ten best-performing stocks of the last decade (only taking large-cap corporations into account). The list was published by the financial and investing advice company 'The Motley Fool.'[21] If you had (intelligently)

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[19] Bebchuck, Lucian A. and Tallarita, Roberto. 2020. 'The Illusory Promise of Stakeholder Governance.' *Working Paper*. March 2020.
[20] Skapinker, Michael. 2019. 'Responsible Business: Is this Time Different?' *Financial Times*. December 24, 2019.
[21] McKenna, Beth. 2020. 'The 10 Best Performing Stocks of the Decade.' *The Motley Fool*. January 6, 2020.

invested $1,000 in each of these companies in January 2010, you would have made a total of $271,730 in ten years.

What is so interesting about the list is that many of the companies aren't household names. Also, they operated in entirely different industries and economic sectors.

1. Netflix (media-services provider)
2. Domino's Pizza (restaurant chain)
3. MarketAxess Holdings (financial services)
4. Exact Sciences (healthcare)
5. DexCom (medical devices)
6. Cheniere Energy (energy)
7. Transdigm Group (aerospace)
8. Broadcom (semiconductors)
9. Fair Isaac (computer)
10. United Rentals (construction/industrial)

So, what made these companies such an excellent investment in the 2010s? Some companies operated in growth markets (streaming service and aerospace components). But there is more to it than that. Nine out of ten companies are known for taking their stakeholders very seriously. They understand that the digital transformation has forced them (and has also given them the tools) to remain relevant. The key to their success (and the success for any business in these unprecedented times) was to build and maintain relevancy in the marketplace, while also remaining relevant to all the various stakeholders within the organization (e.g., employees and investors).

Relevance in the market means delivering products or services that matter for consumers. Relevancy to stakeholders means offering a meaningful experience that allows individuals to develop a unique identity and related capacities, communicate an image, and participate in a fulfilling collaborative project. These two objectives are interconnected in the sense that a business that remains relevant to stakeholders gives itself the best opportunity to stay relevant in the marketplace.[22]

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[22] See Fenwick, Mark and Vermeulen, Erik, P. M. 2015. 'The New Firm.' *The European Business Organization Law Review*. 16(4): 595-623.

A sceptic might suggest that the claim that companies need to look beyond shareholder value doesn't really add anything new to the existing discussion. That is to say, concerns about stakeholders can be analyzed perfectly well under the old model and that shareholder value maximization already includes – or, at least, has the potential to include – some notion of stakeholder capitalism. In one sense, this is perfectly true. It is possible to say that concerns about stakeholders and ESG are just another aspect of shareholder value; it is simply a question of how one chooses to frame the metric of company success. However, the problem is that by framing the issue *exclusively* in terms of shareholder value it immediately creates a series of adversarial and hierarchical relationships between the different groups of stakeholders within a corporate organization that has the potential to distort incentives in various damaging ways.

The problem is not so much that the existing theory is wrong, as such. Rather, it is incomplete and potentially misleading to focus *only* on maximizing shareholder value. Such an exclusive focus has the potential to result in negative behavioral outcomes. Most obviously, it incentivizes short-term 'window-dressing' on the part of managers and employees who wish to portray a positive image of recent performance in order to satisfy investors. An explanation would be that the corporate strategies of successful companies include environmental and social factors – together with good (or, at least, better) governance. For sure, companies often use ESG-statements as marketing tools to respond to the growing societal and political pressure to be more responsible.

But, it's not all jargon. We must distinguish between companies that focus on 'looking good' instead of 'being good.' Yes, you can fake authenticity, but there are ways to operationalize and 'measure' genuine authenticity as well.

This becomes clear when we look at the eleven best and eleven worst stocks of the 11-year 'bull market' (from 2009 to 2020) that was published by American publisher of business forecasts, Kiplinger, on May 13, 2020 (see Table 1).[23] What is interesting is that, at first sight, both the best and worst stock price performing companies are all serious about ESG reporting. At least, it is easy to find statements on either their corporate websites or other public documents to that effect.

This isn't surprising since many of the worst stocks over the last eleven years are energy companies and there has been significant pressure on these companies to be more socially and environmentally responsible.

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[23] Available at: https://www.kiplinger.com/slideshow/investing/t052-s001-11-best-and-11-worst-stocks-11-year-bull-market/index.html.

Table 1: The Best & Worst Stocks from 2009-2020

Company	11-year change	Company	11-year change
Jazz Pharmaceuticals	+20544.8%	PG&E	-59.8%
Nextstar Media Group	+18362.3%	First Solar	-60%
Lululemon Athletica	+9635%	Murphy Oil	-60.5%
Entegris	+9128.1%	Mosaic	-64.6%
Exact Sciences	+8307.7%	Devon Energy	-65.6%
Dexcom	+8182.1%	Marathon Oil	-67.8%
LendingTree	+7104.1%	Fluor	-73.6%
Netflix	+6608.5%	EQT Corp.	-77.8%
Insulet	+6169.2%	Range Resources	-92.7%
Ulta Beauty	+5880.9%	Transocean	-95.1%
Domino's Pizza	+5771%	Chesapeake Energy	-98.5%

Source: Kiplinger

Nevertheless, when you compare the best and worst performing companies there are some valuable lessons to be learned about the sincerity and effectiveness of ESG statements and strategies. In particular, it highlights the importance of identifying and developing metrics that can help us to judge whether a company is being authentic in its ESG-related activities or not. By way of an introduction, here are four signals of genuine commitment:

Effective Action, Not Fancy Slogans

The strategies (and public statements) of the companies at the 'bottom' of the rankings are usually 'over-produced' or bland – coming across as an empty, box-ticking exercise done for the purposes of appeasing criticism of a firm's activities. Such autopilot corporate strategies and approaches are much less likely to work anymore. Both investors and the public more generally are increasingly able to identify general, empty slogans. The marketing people and the consultants can't be left to come up with fancy words and images that look and sound great but mean nothing.

ESG statements and strategies need to be actionable, and any proposed actions must be tangible and plausible.

But a strategy isn't simply about talk. It also needs to be about action. A firm needs to be able to present tangible evidence and a narrative that demonstrates that ESG-words have been put into action.

A Clear Identity that Engages Everyone

There needs to be clarity and consistency on all aspect of corporate operations. ESG strategies must be lived and valued at every level within the company from the top down. Employees, investors, and also consumers and other stakeholders must become part of the ESG strategy. Everyone must be able to identify themselves with the company's commitment to being a more responsible social citizen. In this way, ESG needs to become part of everything a company says and does. It's not simply about 'giving back' to communities. It's about building communities and engaging with communities when it comes to innovation and the development of new products and services.

Lots and Lots of Traceability

Actions create an identity, and – done right – that identity leaves a traceable history that reveals a sustained commitment to a particular set of values. And this isn't only about corporate statements and reports – 'other' forms of disclosure (websites and social media, for example) are also helpful when it comes to traceability. Making a strategy traceable is crucial, as it encourages accountability, as well as demonstrating commitment. Particularly, if an approach is controversial – in the sense that it doesn't follow the current flow of ideas or events – traceability can help create and maintain long-term trust, even when a firm does something controversial or is 'caught out' in a particular situation.

Reflect, React, and Act Again

Traceability also creates transparency, which invites reactions, suggestions, and comments. Such feedback requires corporate leaders to be more reflective and helps them re-think future actions and the entire corporate identity, if needed. Reflection is essential. It keeps everyone vigilant and ensures that 'being good' will not transform into just 'looking good.' The better performing stocks invite stakeholders to share ideas; they have established grievance mechanisms and created an open culture that allows stakeholders to identify themselves with the corporation, learn, and participate in the decision-making process.[24]

On this view, defending stakeholder capitalism and ESG strategies are not only about fairness or doing the 'right thing.' It is also about maximizing performance for the benefit of all. They are about social meaning *and* making money.

So, is coronavirus accelerating the acceptance of stakeholder capitalism? It is too soon to say. But it has shone a light on corporations that promote socially desirable values. It has made more people realize that a myopic focus on profits, and financial returns for investors, can hurt companies and society. The financially driven corporate world is losing its appeal. Intelligent investing of the future might address these concerns by focusing on publicly listed corporations that take a more stakeholder-oriented view.

4. 'Intelligent Investing' in Private Markets? New Accreditation and Smart Contracts

On a podcast in April 2020, US angel investor Jason Calacanis offered an interesting thought.[25] He was discussing how to make 'intelligent' investment decisions. As we do here, he was referring to, risky but smart investments, and he also believed we need to encourage this kind of behavior. At one point during the show, he predicted that the 'democratization of private company investing' is the future.

In theory, everybody can put their money to work and invest directly or indirectly in companies whose shares are traded in public and open markets. You don't have to be a professional investor or satisfy one or more requirements regarding income, net worth, or professional experience. Anyone can go online and immediately buy shares in publicly listed corporations.

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[24] J.A. McCahery, M. Fenwick, and E.P.M. Vermeulen, 'The Future of Capitalism: 'Un-Corporating' Corporate Governance', in J. Farrar and S. Watson (editors), *Contemporary Issues in Corporate Governance*, Canterbury: Canterbury University Press 2017.

[25] See https://fs.blog/knowledge-project/jason-calacanis/.

But this isn't sufficient if we want to rebuild the economy. Even if you believe that stock markets are going to rebound in the post-coronavirus economy, it will still be challenging for the general public, including individual and retail investors, to make money in these public markets. Entrepreneur and investor Naval Ravikant described the problem in September 2019 as follows:

> By the time a company goes public, you can bet anybody with connections, an appetite, investing skills, and capital got a bite at it. So, if you're investing in a tech company's initial public offering (IPO), you are literally last in line. That's not to say you can't make money – but the odds are lower because the fruit has been picked over many times.[26]

As we have seen over recent decades, investing in younger, private companies (whose shares aren't publicly traded) can be much more lucrative. Even small investments in private companies can lead to significant returns. A 200x or more return isn't unheard of.

Recognizing this opportunity, a number of online platforms emerged post-financial crisis to cater to this market. Perhaps the most well-known online exchange for shares in private firms was the New York-based SecondMarket, which rose to prominence after becoming the main platform for trading shares in Facebook when it was still private.[27] The sellers of shares traded in SecondMarket were mainly the former and current employees of firms, with founders also unloading their stock from time to time. The main competitor of SecondMarket was California-based SharesPost. SharesPost started operations in 2009 with the specific aim of dealing with 'the lack of market liquidity for private company shares.' Most of these transactions involve the sale of partial positions held by these individuals, which allows them to obtain a measure of liquidity without losing the chance to participate in a future IPO or a sale to a corporate acquirer.

However, private company investing is mainly available to so-called accredited or professional investors.[28] Institutional investors, DLD (doctors, lawyers, dentists) investors and other wealthy individuals who meet the restrictive investment requirements. Under U.S. Federal Law, for example, current accredited investor definitions are based on income and wealth. $300,000 in

[26] Ravikant, Navel. 2019. 'IPOs are the Last Investors in Line.' *Spearhead* September 20, 2019. Available at: https://spearhead.co/ipo.
[27] Cain Miller, Claire. 2009. 'With Private Trades, Venture Capital Seeks a New Way Out.' *New York Times* April 22, 2009. Available at: https://www.nytimes.com/2009/04/23/technology/start-ups/23vc.html.
[28] See https://fs.blog/knowledge-project/jason-calacanis/.

combined household income or $1m in net worth, excluding the primary home. Those thresholds were set in the early 1980s and have not been updated.[29] These legal rules and regulations are designed to protect the less wealthy by not letting them take any risk in less transparent private markets. Although there has been discussion in the past about loosening the restrictions, they have remained unchanged.[30]

The result is that demand for private company investing has traditionally been driven mainly by venture capital funds, who execute almost half of the trades, as well as by already wealthy accredited individuals, institutional investors, and hedge funds. This is why it did not take long for clever entrepreneurs in the US to create and further develop online platforms to facilitate better pre-IPO trading in the shares of non-listed venture capital-backed firms. They were able to avoid compliance with strict securities rules and regulations by limiting access to trading to accredited investors. Unsurprisingly, these trading platforms fast became a critical component of the venture capital ecosystem, as they helped bridge the liquidity gap in the venture capital model.[31]

This restrictive approach seems short-sighted in a post-crisis situation. Yes, equity-based crowdfunding initiatives already allow investors to place bets and buy into private companies, regardless of their net worth or income. But investment opportunities are still limited and subject to regulatory restrictions. If we want to rebuild the economy in the post-coronavirus world, we have to create more equal opportunities for prosperity and wealth for everybody.

Allowing both accredited and traditionally, non-accredited investors to invest and trade in private companies more freely could bolster and empower the low-income and middle classes and help to ‘re-risk’ the economy.

Of course, making bets in the private markets is risky, and not every investment will be successful. Yet, we should realize that individuals currently defined as non-accredited may be ‘sophisticated’ and not in need of protection. At least for certain types of investment. They may have the skills and experience to make good investment decisions in fast-growing start-up companies at a relatively early stage.

[29] Lex. 2020. ‘Accredited Investors: Slow Boil.’ *Financial Times*, January 7, 2020. P.12.
[30] Ibid.
[31] Mendoza, Jose, M. and Vermeulen, Erik, P.M. 2011. Birkmose, Hanne S., Neville, Mette, and Sørensen, Karten Ensig (eds.), *European Financial Market in Transition*. AH Alphen aan den Rijn: Kluwer Law International. P. 383-420.

Think of a nurse who wants to invest in a health tech company that offers services to hospitals. Nurses have the skills, experience, and know-how necessary to understand the innovation. They certainly have more insight than the average non-healthcare worker or – a better comparison – a wealthy-but-less-knowledgeable investor. A private company investment course might arguably make them more sophisticated investors who are able to take 'intelligent risks.'

Other examples are teachers who wants to invest in ed-tech companies. Or, cooks who are interested in investing in food-tech. Also, wouldn't it be great if a legal secretary or paralegal would be allowed to invest an amount of her monthly income in a LegalTech start-up? Again, a relatively small amount would do the trick. The risk would then be relatively low, but the returns could be significant. And such investments would provide capital for new companies and founders that might otherwise struggle to find funding in a difficult post-crisis economic environment.

In fact, in December 2019, the U.S. Securities and Exchange Commission voted 3-2 to expand the definition of an accredited investor. As summarized by Jeffrey S. Hochman and Mark S. Vandehaar, the proposed amendments to the accredited investor definition in Rule 501(a) of Regulation D would:

- 'Add new categories to the definition that would permit natural persons to qualify as accredited investors based on certain professional certifications and designations, such as a Series 7, 65, or 82 license, or other credentials issued by an accredited educational institution;
- With respect to investments in a private fund, add a new category based on the person's status as a 'knowledgeable employee' (as defined under the Investment Company Act) of the fund;
- Permit limited liability companies with total assets in excess of $5 million that were not formed for the specific purpose of acquiring the securities offered to qualify as accredited investors;
- Add 'family offices' with at least $5 million in assets under management and their 'family clients,' as each term is defined under the Investment Advisers Act; Add a new category for any entity, including Indian tribes, owning 'investments' (as defined under the Investment Company Act) in excess of $5 million and that was not formed for the specific purpose of investing in the securities offered; and

- Extend the accredited investor definition so that 'spousal equivalents' may pool their finances for the purpose of qualifying as accredited investors, regardless of whether they are investing jointly.' [32]

The SEC requested comments on these proposals. The received comments and media response reveal many of the traditional arguments in favor of such restrictions, particularly investor protection.[33] Privately held companies are not required to disclose audited financial statements, making their securities difficult to value. Moreover, investments in private equity or venture capital take longer to redeem, so investors must bear risk of losses over a longer time frame. Even the most experienced investors often fail to estimate accurately how much private companies are worth. The SoftBank–WeWork case providing a recent example of an investor (the Softbank Vision Fund – Masayoshi Son) badly misjudging the value of a private company (in this case the workspace sharing company WeWork and its founder Adam Neumann). According to critics, the need for investor protection still justifies the more restrictive rules. The debate in the U.S., and elsewhere, around this issue is on-going.

And yet, this is where technology might come in as a mechanism to provide an additional layer of protection. The blockchain was one of the top tech trends between 2016-18. Conferences. Workshops. Seminars. Blockchain was hot and attracted a lot of attention from governments, businesses, capital markets, and researchers. There wasn't a problem that blockchain and its related technologies couldn't solve.

A natural reaction to all this hype is fatigue. 'Aren't we all just fed up hearing about Bitcoin and Ethereum?' – as Scott Galloway wrote in a Medium post of April 21, 2020.[34] We can all understand this sentiment. By 2019, the hype slowed down, but the interest never disappeared. Many of the earlier blockchain initiatives hoped to start a revolution. The idea was to challenge or

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[32] Hochman, Jeffrey S., and Vandehaar Mark A. 2020. 'Regulatory Monitor.' *Investment Lawyer*. 27(3) March 2020, 50-52. P. 50. On the details of the SEC proposal itself, see https://www.sec.gov/rules/proposed/2019/33-10734.pdf.

[33] For the comments on this and similar previous SEC proposals to open up the class of accredited investors, see https://www.sec.gov/comments/4-692/4-692.shtml.

[34] Galloway, Scott. 2020. 'Why Amazon, Apple, Facebook, and Google Look Even Stronger in a Pandemic.' *Medium* April 21, 2020. Available at: https://marker.medium.com/post-corona-the-four-8cbca794396c.

disrupt existing centralized institutions and systems and harbor in a decentralized future. This was both ideological and political – a 'blockchain revolution.'[35]

Take the first decentralized autonomous organization (The DAO) launched in 2016.[36] This was a blockchain-based effort to organize a new style company – a 'software-run' corporation without managers, without a CEO or directors. While this project had the noble goal of introducing more radical forms of democracy and equality into corporate systems, it now looks overly naïve to believe that decentralized technology could ignore two hundred years of economic history and change the world.

But things may be different now. Solutions that leverage blockchain technology in more modest, yet practical ways, have the potential to become useful in a coronavirus world. We already see an increase in blockchain projects that are designed to provide more transparency and trust in healthcare and drug supply chains.[37] Existing blockchain projects are being rebranded to help distinguish between reliable information and fake COVID-19 news.[38] Blockchain-enabled technology is being introduced to store virus data and keep track of patients, while protecting privacy.[39]

Moreover, blockchain and smart contacts can be instrumental in the development of vibrant and sustainable markets for private company investments. Smart contracts are simply computer programs that control the transfer of assets and which are stored on blockchain.[40]

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[35] See, for example, Reed, Jeff. 2016. *Blockchain: The Essential Guide to Understanding the Blockchain Revolution*. New York: Createspace.

[36] See Fenwick, Mark and Vermeulen, Erik, P. M. 2019. 'Technology and Corporate Governance.' *The Texas Journal of Business Law*. 48(1): 1-22; Fenwick, Mark, Kaal, Wulf, A., and Vermeulen, Erik, P. M. 2019. 'The 'Unmediated' and 'Tech-Driven' Corporate Governance of Today's Winning Companies.' *New York University Journal of Law and Business*. 16(1): 75-121.

[37] Degnarian, Nishan. 2020. 'Five Ways Blockchain Can Unblock the Coronavirus Medical Supply Chain.' *Forbes*. March 22, 2020.

[38] Partz, Helen. 2020. 'Italy's Top News Agency Uses Blockchain to Fight Fake Coronavirus News.' *Cointelegraph*. April 7, 2020.

[39] Allison, Ian. 2020. 'World Health Organization Teams With IBM, Oracle on Blockchain-Based Coronavirus Data Hub.' *Coindesk*. March 27, 2020. Nelson, Danny. 2020. Researchers Are Tapping Blockchain Tools in Fight Against Coronavirus. *Coindesk*. April 9, 2020.

[40] See generally, Corrales, Marcelo, Fenwick, Mark, and Haapio, Helena (editors). 2019. *Legal Tech, Smart Contracts and Blockchain*. Berlin: Springer.

The idea of introducing blockchain technology to stimulate investments in private companies isn't new. Distributed ledgers that hold a full record of the ownership and transaction history of the securities build trust in the private market and help streamline the investment process.

Introducing a blockchain-based trading and settlement infrastructure makes sense in the underdeveloped markets for private company shares. These markets aren't captured by the centralized, server-based clearing and settlement platforms (which are the status quo in the established public and open markets).

The use of smart contracts (computer protocols) can further automate the investments and trade of private company shares without the need for intermediaries, thereby significantly reducing time, costs, and error. The problem with the current approaches is that they focus on programming existing compliance rules into smart contract protocols, ensuring that only accredited investors can invest in private companies.

But in a post-coronavirus world, we will need to change the conversation and 're-risk' the economy. Blockchain technology and smart contracts have the potential to optimize the investment rules and regulations regarding private company investing. When we program the possibility of 'intelligent risk-taking' by everybody (both accredited *and* traditionally non-credited investors) into the computer protocols for private company investments, we disintermediate the investment and trading process. In addition, we create more liquidity in the market (making the risk-taking more intelligent in aggregate).

Smart contract protocols might then contain requirements regarding the obligation to follow an investment course (only 'sophisticated' investors are allowed to buy into a private company). We can also think of other investment restrictions. For instance, non-accredited, but sophisticated individual investors can only invest in certain sectors (dependent on their expertise). Or investments are restricted to certain types of company or locations).

The economic downfall that has been trigged forces us to re-risk the economy. And, blockchain technology has the potential to play an essential role in building the next reality. It may not be the revolution envisaged by the blockchain evangelists of 2017/18, but it could still prove enormously significant in the post-virus recovery.

Re-building the economy post-crisis will require 're-risking.' Such a project requires imagination and experimentation. We should not simply go 'back to the future.' Instead, we would be better off embracing the opportunities that are inevitably created during a crisis and looking to foster more sustainable and democratic forms of corporate behavior and capitalism.

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