Ownership, Agency and Trusteeship

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This article draws on the work of many people in particular those associated with programmes of research at the British Academy, Oxford University and elsewhere – John Armour, Marco Becht, Clare Chapman, Paul Collier, Alex Edmans, Jeff Gordon, Tom Gosling, Will Hutton, Jay Jakub, Molly Morgan Jones, John Kay, Bridget Kustin, Mary Johnstone Louis, Philip McCann, Sudhir Rama Murthy, Dalia Palombo, Henry Richards, Bruno Roche, Jacob Schumacher, Judith Stroehle, Peter Tufano, Belen Villalonga, Boya Wang and Charles Wookey. It has benefited from comments by the editors of the Oxford Review of Economic Policy, and Hanoch Dagan, Julian Franks and Charlotte Ostergaard. It has drawn on research funded by grants from the British Academy Future of the Corporation programme; the ESRC/NIESR programme on Rebuilding Macroeconomics: Decentralized Reciprocity; the Ford Foundation programme on Ownership; the Mars Catalyst programme on the Economics of Mutuality; and The Purposeful Company programme. The views expressed in this article do not necessarily reflect those of any contributor to this issue of the Oxford Review of Economic Policy.

Abstract

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JEL Classifications: K11, K22

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This article argues that the two dominant concepts of theory of the firm and the bases of modern management education, business practice, and public policy towards the firm, namely shareholder primacy and agency theory, are at best incomplete and at worst erroneous. They omit what was a substantial basis of discourse on the company in the first half of the 19th century, namely the notion of trusteeship. The article argues that reintroducing trusteeship addresses many of the current debates around capitalism, explains the bewildering patterns of ownership observed around the world, accounts for the recent failures of capitalism, and is a potential source of enhancing firm performance in the future.

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"Property is that sole and despotic dominion which one man claims and exercises over the external things of the world, in total exclusion of the right of any other individual in the universe." William Blackstone (1765), *Commentaries on the Laws of England,* Oxford: Clarendon Press, Book 2, Ch. 1.

Blackstone's statement is the basis of modern theory of property and concepts of ownership. It underpins the two dominant concepts of theory of the firm, namely what are termed shareholder primacy and agency theory, and has established modern management education, business practice, and public policy towards the firm. This article argues that it is at best incomplete and at worst erroneous. It omits what was a substantial basis of discourse on the company in the first half of the 19th century, namely the notion of trusteeship. The article suggests that reintroducing trusteeship addresses many of the current debates around capitalism, explains the bewildering patterns of ownership observed around the world, accounts for the recent failures of capitalism, and is a potential source of enhancing firm performance in the future.

In August 2019 the Business Roundtable in the US revoked a 22-year old statement that "the paramount duty of management and of boards of directors is to the corporation's stockholders".[1] In its place, it put a statement of corporate purpose regarding the commitments of business to their customers, employees, suppliers, communities, the environment and shareholders.

It was interpreted as a schism between business and the Friedman Doctrine, named after its author the Nobel Prize winning economist Milton Friedman, who stated in 1962 that "there is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud."[2]

The Council of Institutional Investors reacted immediately by saying that "accountability to everyone means accountability to no one" and observing that the Business Roundtable had referenced "shareholders simply as providers of capital rather than as owners".[3] It also noted the "real world dynamic of public equity markets" and that while "no doubt company managers often are frustrated by a sense that they are vulnerable to changes in company valuation that can be rapid", "shareholders have a very particular role in allocating (and re-allocating) equity capital". At the heart of the debate therefore lie three central concepts – accountability, equity markets and ownership.

According to conventional views, capitalism is an economic system of private ownership of the means of production and their operation for profit. In that context, ownership is a bundle of rights over assets that confer strong forms of authority on its possessors. Tony Honoré (1987) describes those rights in eleven constituent components: 1) the right to possess; 2) the right to use; 3) the right to manage; 4) the right to income; 5) the right to capital; 6) the

[1] Business Roundtable Statement on the Purpose of a Corporation, August 19, 2019.
[2] Friedman, Milton (1962), *Capitalism and Freedom,* Chicago: Chicago University Press, p. 133.
[3] Council of Institutional Investors Responds to Business Roundtable Statement on Corporate Purpose, August 19, 2019.

right to security; 7) the incident of transmissibility; 8) the incident of absence of term; 9) the prohibition of harmful use; 10) the liability to execution; and 11) residuary character.[4]

Accountability of boards of directors is therefore perceived to be to their shareholders. This is reflected in company law in the UK which states that "the director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefits of its members as a whole, and in doing so have regard (amongst other matters) to the likely consequence of any decision in the long term"[5] and other stakeholders to the firm, such as its employees, suppliers, customers, community, environment and reputation.

This article questions conventional notions of ownership by arguing that they are neither theoretically justifiable nor practically relevant. The Blackstone concept of property is particularly inappropriate and detrimental in the context of commercial activities that have the potential for advancing human wellbeing. Its erroneous application has been a source of economic, social and political instability and growing crises in distribution of income and wealth, environmental degradation and disaffection amongst large swathes of developed and developing country populations. The despotic has become sclerotic and its correction requires a fundamental reconceptualization of the nature of ownership, business and our capitalist systems.

Concepts of Ownership

There are two aspects to the ownership of a firm. The first is a claim over the earnings of a firm and the second are control rights over the governance of a firm that extend beyond those of other parties to the firm. The two are intimately intertwined. The control rights are required to protect shareholders from the risks to which they are exposed of expropriation of their earnings by other parties to the firm, including those employed to manage their assets on their behalf. They therefore have rights of appointment, removal and remuneration of directors and influence over key decisions taken by the board of directors.

The association of shareholding with property is by analogy. Shareholders invest in companies in a similar way to how they purchase cars, houses and washing machines. They therefore have similar claims over both the benefits and employment of the assets of a firm. Their influence is mediated by the boards of directors who are appointed as their agents, but ultimate authority resides with shareholders as providers of capital. Impediments to the exercise of those rights is an intrusion on liberty equivalent to that on any other form of property.

There are three reasons why the analogy is vacuous, and even if ever of any substance, it is increasingly not so. The first is that shareholders do not fund the assets of the firm. For the most part you can run your car, home and washing machines essentially on your own. That is clearly not the case of General Motors and not even of anything other than the smallest firms. On the contrary, firms are highly complex methods of coordinating the activities of a

[4] Honoré, Tony, (1987) *Making Law Bind*, Oxford: Clarendon Press 1987, 166–79.
[5] S.172 of the UK Companies Act, 2006.

vast array of individuals and organizations, which no one individual or group of individuals finances or controls. Second, while the responsible usage of a car, home and washing machines has limited effects on others, that is blatantly not true of General Motors or even modestly sized companies - the effects of General Motors are felt globally and the corner shop locally.

Quite reasonably then the property rights of shareholders over firms are much more restricted than individuals over their possessions, but, third, even if the property right analogy was ever applicable to firms, it is of rapidly diminishing significance. It emerged in the context of the industrial revolution and the rise of manufacturing industry when companies employed physical capital that required large amounts of financing from investors. In contrast, today, it is not plant and machinery on which firms are predominantly dependent but individuals, information, knowledge, computer algorithms, brands and reputations – what are collectively termed "intangible assets" to contrast them with their traditional tangible forms.

There are several implications of this. The first is that the amount of financing that companies require has diminished appreciably. Typically, a high-tech firm will initially raise relatively modest amounts of finance in stages and then seek to fund its expansion through the revenues it generates. Second, in marked contrast to traditional manufacturing, firms increasingly do not own the assets on which they depend. They do not own their employees, societies and environments and they do not own many of the organizations with which they interact in their supply and distribution chains. Instead, they coordinate and invest in a wide array of parties and organisations that lie beyond the property right boundaries of the firm.

The 21st century firm therefore comprises a set of intangible assets of a human, intellectual, natural and social form that they do not possess but on which they are dependent and have an increasingly significant effect. For example, the impact of Facebook and Google is global not only in terms of their multinational operations but also the nature of their products. This has profound implications for the way in which we should conceive of their ownership and governance. It turns the traditional property right view of the firm on its head. Firms are no longer bundle of assets owned by those who have financed them, and they do not have owners whose rights derive from the property they have financed. On the contrary, they are dependent and have effects on assets that they have not purchased and do not possess. They are therefore bundle of assets outside of a legal boundary of the firm that require coordination but not through control rights that are associated with their financing.

In other words, what this points to is the need to separate what has been a traditional association of control with financing. As an economic system of private ownership of the means of production that confers strong forms of authority of their possessors, capitalism presumes the allocation of control rights to providers of capital, in particular those who bear residual risks of profits and losses, namely the shareholders.[6] If that ever was appropriate,

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[6] Residual right and agency theories in economics are particularly associated with Ronald Coase (1960) "The Problem of Social Cost," *Journal of Law and Economics,* 3, 1- 44; Harold Demsetz (1967), "Toward a Theory of Property Rights", *American Economic Review,* 57, 347-359; Sanford Grossman and Oliver Hart (1986) "The Costs and Benefits of Ownership: A Theory of Lateral and Vertical Integration," *Journal of Political Economy,* 94, 691-719; Oliver Hart (1995), *Firms, Contracts and Financial Structure*, Oxford: Oxford University Press; Michael

and for the reasons mentioned above it is questionable whether it was, it no longer is. The dependence and impact on other parties – employees, suppliers, communities and nature - makes them as, if not more, relevant to the success of a firm and exposed to its risks of failures.

Enlightened Shareholder Capitalism

Business and government of course recognize this and incorporate wider interests of society in their operations and policies. As noted above, the UK Companies Act makes reference to directors having regard to the interests of stakeholders as well as their shareholders, and the institutional investment community is increasingly concerned about the impact that environmental and societal factors have on the value and risks of their investments.

But the law states that directors should only have regard to the interests of others to the extent that this promotes the success of the company for the benefit of its shareholders. And institutions should only incorporate environmental and societal factors to the extent that they are relevant to their investors. Neither firms nor institutions should stray beyond their shareholder interests; to do so would be in violation of their agency relationships to their principals and represent potential theft of shareholder property.

This is what is generally referred to as "enlightened shareholder interests", namely enlightened in recognizing the contribution that the well-being of others can make to shareholders. It is sometimes put in terms of the "genius of the and"[7] - creating benefits for society *and* greater returns for shareholders – or the phrase "doing well by doing good" – well for shareholders and good for society. Arguably, these blithe notions of enlightened shareholder interests, the genius of the and, and doing well by doing good are what underpinned the Business Roundtable corporate purpose statement - in which case the Council of Institutional Investors need not have taken fright.

The problem that this sweeps under the carpet is what happens if there is an inevitable "or" in choosing between societal and shareholder benefits, and companies do well by doing bad not good, as arguably the "sin stocks" of alcohol, tobacco, gambling, arms manufacturing and fossil fuels do all the time. Put differently, businesses should, and directors have a duty to, avoid paying taxes, pollute the environment, minimize their labour costs, source from the cheapest global suppliers to the extent that these do not fall foul of the law or impose reputational costs that outweigh the savings they make by so doing – what might be regarded as enlightenment in the eye of the beneficiary but no one else.

It is sometimes suggested that the problem is predominantly one of time, namely "short-termism". So long as companies are focused on creating long- as against short-term value then all's well that ends well – or preferably doesn't end because the other term that is used in this regard is "sustainability" - building sustainable businesses for the future. But the long-term looks bleak for the impoverished if they thereby remain impoverished or for inequality if everyone just progresses in tandem. And sustainability of businesses that is achieved

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Jensen and William Meckling (1976), "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure", *Journal of Financial Economics,* , 3, 305-360.

[7] Jim Collins (1994), *Built to Last,* London: Random House Press.

through insurance does nothing to address environmental and climatic problems; it simply externalizes and potentially exacerbates them. The problem is not just a horizon one but what and whose horizon.

A second suggested solution is to recognize that at the end of the chain of shareholders are ultimately people who have an interest not only in their wealth but also their health, survival, descendants and security – namely their prosperity and wellbeing. They are concerned not only about financial returns but also how those returns are generated.[8] This has been reflected in the growth of "impact investing" in which investors seek positive human, social and environmental impact from their investments as well as, and potentially at the expense of, financial returns. Shareholders are not all the same. Some are only interested in financial returns; others are not. They have different preferences and time horizons in regard not only to financial performance but societal ones as well.

There are two problems with this resolution. The first is that, while growing, the size of the impact investing market remains modest in relation to the conventional value maximizing one. Institutions therefore still regard their primary function as being to identify and promote the greatest financial returns on their investments. The second problem is that, the quality, comparability and reliability of non-financial measures of corporate performance that are available for investors are poor in relation to their financial equivalents. Institutional investors therefore feel better able to allocate resources on financial than non-financial considerations.

The reason why these discussions about the length and breadth of interests of investors are unsatisfactory is that they do not address the central question, which is not whether investor horizons are sufficiently long or broad but whether they have absolute rights to express and implement them. This view derives from the property concept according to which investors own firms by virtue of their investments. They have invested therefore they own – period – and there is nothing further to discuss. The only question which needs to be answered is what investors want of their property – the length and breadth of their interests - and it is for the intermediary institutions and the firm to determine and act upon this.

Privilege Not Property

The thesis of this article is that this is fundamentally wrong. The creation of a corporation is not a right. It is a privilege to employ a legal concept to construct an artificial entity that has the potential to produce untold wealth, prosperity, inequality and misery in equal measure. It is sometimes suggested that limited liability, by which shareholders are only liable for the capital they have invested, is the privilege of incorporation. This is one but only of its benefits. More substantially, it provides its founders with the ability to establish a body that is distinct from those who create and run it. That privilege has substantial obligations to ensure that it is used wisely not only for the benefit of its creators and owners but for all who engage with and are affected by it. The failure to embed this responsibility in the intrinsic conceptualization of the firm as against its extrinsic regulation from the introduction of

[8] Oliver Hart and Luigi Zingales (2017), "Companies Should Maximize Shareholder Welfare Not Market Value", European Corporate Governance Institute, Finance Working Paper Series, no. 521.

freedom of incorporation in the 19th century was a fundamental error of omission for which we are now paying the true costs.

If not property, what is a firm? Some people argue that it is a system for managing the assets and people for the benefit of its customers.[9] At the heart of it lies the governance of its stakeholders, and some have argued that one should abandon the notion of corporate ownership altogether and subsume it under governance. Firms comprise complex organizational arrangements that rely and depend on a large number of different parties associated with which there should be different forms and degrees of governance and accountability. The parties who are most relevant to the determination of the appointment, removal of members of the board of directors, their remuneration and major policy decisions are those most relevant to and impacted by them.

This is attractive in demonstrating the variety of forms of governance that underpin the successful operation of companies. Instead of viewing corporate governance as being just about solving the agency problem of aligning managerial interests with shareholders, it involves relating it to the different parties who affect and are affected by the firm. Shareholders are one but only party in that regard and their governance rights should be considered alongside those of employees, suppliers, communities and future generations.[10]

Attractive though this might appear to be to many, for others it is the thin edge of a wedge of disempowering shareholders and creating an unworkable form of governance. Indeed, to discard ownership altogether is not the right approach. It undermines the capacity of ownership to resolve conflicting interests in a manner that does not require the engagement of a vast array of different parties to the firm. We need to be very careful before concluding that we can dispense with corporate ownership altogether and substitute an alternative organizational arrangement for it. However, for ownership to fulfil its potential, it has to recognize its responsibility to the interests of others as well as its rights to itself and in particular to promote the purpose of the company for benefit of others.

The problem is not ownership but the way in which we have equated it with the rights of property without the responsibilities of trusteeship. A trust is defined as "a legal device developed whereby ownership of property is split between a person known as a trustee, who has the right and powers of an owner, and a beneficiary, for whose exclusive benefit the trustee is bound to use those rights and powers."[11] The agency view of the board is of the directors as agents of the owners. The trusteeship view is that the board is there to manage the company for the benefit of the parties in whose interests the company is established. Those parties are defined by the reason why the firm was created, why it exists, what it is there to do and what it aspires to become – in other words its purpose. So, before we can understand the implications of trusteeship for ownership, we need to define purpose.

[9] See, for example, John Kay (2019), "The Concept of the Corporation", *Business History.*
[10] Amir Licht (2019) "Stakeholder Impartiality: A New Classic Approach for the Objectives of the Corporation", European Corporate Governance Institute Working Paper No.476, proposes a duty of impartiality of directors to their different stakeholders.
[11] Fratcher, WF (1973) *International Encyclopaedia of Comparative Law*, JCB Moh, 60.

What is Purpose?

As Edward Freedman, the originator of stakeholder theory, has noted, just as we breathe to live but don't live to breathe, so business profits from purpose but its purpose is not profits.[12] Profits are a product of business not a purpose *per se.* The purpose of business is to solve problems in ways that are commercially viable in delivering profits. In other words, the purpose of business is to produce profitable solutions to the problems of people and planet.

So purpose is not about charity or philanthropy but hardnosed business. It is about delivering profits to shareholders through identifying ways of solving problems of others. Key to this is the way in which profits are measured. At the moment we view profits in terms of their return on financial capital. They are therefore measured net of the cost of maintaining the physical assets that financial capital is used to fund. However, as noted before, the firm depends and has an impact on a range of assets beyond its financial and material capital and profits should reflect the cost of maintaining those assets as well. In other words, profits should not be recorded where they are earned at the expense of other parties.

The purpose of a company is neither just descriptive in describing what it does – produces the most reliable cars, the best value washing machines etc. nor aspirational in claiming to make the world a better place. It is a precise statement of whose and what problems the company is solving, how, when and why the company is particularly well suited to do that. As an illustration, take the example of Novo Nordisk the Danish producer of insulin which is used in the treatment of type two diabetes. While its purpose was originally conceived to be to produce insulin, i.e. descriptive, it was subsequently realized that this was not its fundamental purpose in terms of solving the problems of its customers. Its purpose was to eliminate type two diabetes which might, but not necessarily, involve taking insulin and might be better avoided altogether through changes in people's lifestyles.

The case of Novo Nordisk illustrates how a careful consideration of what problems companies are equipped to address shifts their focus to the commercial delivery of solutions, which is the source of their rewards. By delivering solutions, corporations promote the self-determination of others by providing them with the capability to realize their own purposes. They help endow individuals with the capabilities they require to achieve a fulfilling and meaningful existence.[13] This is what Hanoch Dagan documents in his persuasive liberal reinterpretation of property as a means to self-determination through a combination of pluralism, the establishment and limitations on authority, and the furtherance of relations.[14] In a liberal system we should expect to observe plurality of ownership, the restrained exercise of its authority, and its employment to promote relations. This is a far cry from Blackstone's despotic dominion but closer to the diversity, form and function of ownership that we observe around the world.

Who Are the Owners?

[12] Edward Freeman (2014), "Is Profit the Purpose of Business?" UVA Darden *Ideas to Action, Business Ethcis and Society, August.*
[13] Amartya Sen (1999), *Development as Freedom,* Oxford: Oxford University Press.
[14] Hanoch Dagan (2020), *A Liberal Theory of Property*, Cambridge: Cambridge University Press.

The founder of a company defines its purpose and oversees its implementation through appointing its board and raising its capital, thereby giving meaning to the abstract legal concept of the corporation. Founders pass on and sell ownership to others, to their partners, descendants, families, employees, foundations, firms, other companies, institutional and individual investors in private deals and public offerings on stock markets. These parties in turn inherit not just the rights of shareholders but also the obligations and responsibilities of trustees. Those obligations relate to determining how the firm acts to the benefit and avoidance of detriment to those affected by it. They give rise to the notion of a "natural owner" that is to say the party who is most suited not only to the promotion of the corporate purpose but also to ensuring the delivery of its promised benefits.

There is a remarkable and persistent diversity of ownership around the world which convergence has failed to eliminate. This in itself is an interesting observation in regard to the questions of the nature of ownership raised above because if ownership had just one purpose to make money then ownership around the world would not be expected to display the degree of heterogeneity that is observed in practice. There would be different mutual funds catering to the preferences and horizons of particular investors but beyond that a high degree of uniformity of ownership would prevail. If, on the other hand, ownership also reflects divergent views on the merits of the trustee role of upholding the interests of other parties then the form it will take will be highly specific to the national and regional variations in the emphasis placed on this.

The OECD records that "institutional investors are by far the single largest category of investors accounting for more than USD 30 trillion invested in public equity markets".[15] The reason for this is their significant presence in the UK and the US, and the dominance of, in particular, US global equity markets, accounting for approximately one-third of global market capitalization. However, the UK and the US are also outliers in another respect.

Rafael La Porta et al (1999) document the fact that the conventional description of dispersed institutional ownership as observed in the UK and US is not a feature of most countries.[16] The OECD records that in half of the 35 jurisdictions of their study, 40% of listed companies have a single shareholder with a majority shareholding, and in 24 jurisdictions the three largest shareholders together own a majority shareholding.[17] The two countries with the lowest level of ownership concentration according to the OECD are the UK and US. Elsewhere, ownership is highly concentrated

Belen Villalonga reports that families are the most important owners of concentrated blocks of shares, in general holding between 30 and 50% of publicly listed firms around the world according to her survey of many empirical studies.[18] Private industrial holders are the next largest and institutional investors in third place, with the UK and the US being one of the few markets in which they are the dominant shareholders.

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[15] Adriana De La Cruz, Alejandra Medina and Yung Tang (2019), "Owners of the World's Largest Companies", OECD Capital Market Series, Paris, p. 9.

[16] Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer (1999) "Corporate Ownership Around the World." Journal of Finance 54 (2): 471-517.

[17] Adriana De La Cruz, Alejandra Medina and Yung Tang (2019), *op. cit.*

[18] Belen Villalonga (2020), "Family Ownership", *Oxford Review of Economic Policy,* forthcoming.

Shleifer et al (1999) attribute the presence of concentrated ownership to insufficient investor protection outside of common law countries.[19] However, Raghuram Rajan and Luigi Zingales (2003) record the substantial changes in ownership that have occurred over time and argue that this is inconsistent with the long-term stable distinctions between common law and civil law countries.[20] Something more appears to be driving patterns of ownership. Franks and Mayer (2017) argue that the missing ingredient is trust and that the differences in ownership across countries and time, in particular in the UK, US, Germany and Japan, are a reflection of the trust function that ownership performs in relation to the interests of minority shareholders and other parties to the firm.[21]

The importance of the concentration and nature of ownership relates to the extent of control that owners exercise over companies and their commitments to promoting its activities. The UK began the 20th century with a high level of family ownership with some of the most iconic companies, such as Cadbury's, Rowntrees, Boots and Beecham, being family owned, many Quaker families with high levels of ethical standards. But by the middle of 20th century many of the families had sold out or had their ownership stakes significantly diluted by share issues and acquisitions. As a consequence, families in the UK progressively lost control of their firms and their position as dominant shareholders was replaced by the newly emerging financial institutions, such as pension funds and life insurance companies.

This development significantly influenced the relation of companies to their owners. At the beginning of the 20th century there was a close relation with the concentrated family owners being able to uphold the strong ethical principles of the Quaker families. By the middle of the 20th century this was no longer possible and, with the growing separation between the ownership and control of firms of the type that Berle and Means documented in the US, there was a vacuum in the governance of firms.[22] Increasing dispersion of ownership meant that it was no longer possible for companies to sustain relations with their anonymous shareholders. The response to this was the emergence of the "market for corporate control" – hostile takeovers, which started in the 1950s in the UK and the US, and hedge fund activism which emerged some 50 years later. The UK and US moved from financial systems with strong often long-term relationships between concentrated family owners and their firms to shorter-term transactional forms of corporate control.

Until the beginning of this century, the prevailing view amongst academics was that family ownership was bad. It created private benefits of control in the form of the predominance of private interests of family members over the commercial interests of the firm. However, more recent evidence has called this into question. In particular, Belen Villalonga (2020) reports the positive impact of family ownership on firm performance, the negative impact of family control in excess of ownership, and the positive impact of family management by

[19] Rafael La Porta (1999) et. al., *op. cit.*

[20] Raghuram Rajan and Luigi Zingales (2003), "The Great Reversals: The Politics of Financial Development in the 20th Century." *Journal of Financial Economics* 69, 5-50.

[21] Julian Franks and Colin Mayer (2017), "Evolution of Ownership and Control Around the World: The Changing Face of Capitalism" in Benjamin Hermalin and Michael Weisbach, *The Handbook of Corporate Governance, Volume 1.*

[22] Adolf Berle and Gardiner Means (1932), *The Modern Corporation and Private Property,* Transaction Publishers.

founder CEOs.[23] In other words, family ownership is beneficial, particularly where founder CEOs are involved in management and where family control is not excessive in relation to their ownership.

Surveys record a higher level of trust in family businesses than in other types of companies in many countries around the world.[24] In particular, levels of employee satisfaction are higher in family businesses with employees feeling better cared for, treated and valued and therefore being more committed, devoted and motivated to family than other businesses. However, the surveys also report that families underperform other firms in relation to broader social and environmental measures. It is as if family businesses embrace their employees and local communities but not society or the environment at large.

A particularly interesting aspect of this is when founders decide not to pass on their firms to their heirs either because they don't have them or they don't like them, and instead place them in the hands of foundations and trusts. Industrial foundations, as this type of ownership is termed, is widespread in Denmark and Germany with some of the largest companies in the world such as Bosch, Carlsberg, Ikea, Maersk and Tata, the Indian conglomerate, taking this form. Many of these firms are listed on stock markets and traded actively but their ownership is predominantly in the hands of the foundations which are responsible for upholding the purposes and values of their founders and ensuring that they remain firmly embedded in the businesses.

The importance of block holders be they families or foundations in publicly listed companies is the dual nature of the ownership that they create. Companies simultaneously possess widely held, dispersed shareholdings that are actively traded on stock markets and holders of blocks of shares who retain control of the firms. That duality in essence creates the potential for combining traditional agency relations in relation to the dispersed shareholders and trustee functions in regard to the block holders. At one extreme lie privately held companies with only block holders and at the other dispersed shareholder companies of, in particular, the UK and US; in between are the most widely observed companies with a mixture of the two. We should be careful to ensure that regulation and investor protection do not impede the competition, or "horse-race" as Julian Franks describes it, that is required to identify the most successful and durable forms of ownership.[25]

There are pronounced changes in progress in this regard. René Stulz discusses the demise of listed companies in the UK and US.[26] The number of listed companies in the UK and US has halved over the last two decades in both countries while remaining relatively constant in aggregate around the world. The dispersed Anglo-American ownership system appears to be losing out to others and in particular being replaced by a growth of private equity.

The growth of private equity is sometimes argued to reflect the superiority of private over public markets. Private equity is viewed as addressing the agency problems that afflict public

[23] Belen Villalonga *op. cit*.
[24] Edelman Trust Barometer (2017), "Special Report: Family Business".
[25] Julian Franks (2020), "Institutional Ownership and Governance", *Oxford Review of Economic Policy,* forthcoming.
[26] René Stulz (2020), "Public Versus Private Equity", *Oxford Review of Economic Policy,* forthcoming.

markets through greater concentrations of ownership and higher-powered incentive arrangements. However, Morris and Phalippou suggest they may also introduce their own agency problems in particular through the "general partners" managing portfolio companies in which they invest to their own advantage.[27] It is an empirical question of whether private capital does indeed outperform public markets.

Answering this is complicated by the lack of transparency and paucity of information available on private equity. To the extent that it is possible to compare performance then private markets do appear to outperform or at least do as well as public markets, in particular in relation to unlisted companies rather than public companies going private. However, this raises questions about the source of the outperformance and whether it comes at the expense of other parties to the firm, for example, employees and local communities.

There is little support for the claims of wealth transfer at the expense of employees but there remain concerns about the extent to which the growth of private capital markets is diminishing access of investors to equity investments, the unequal regulatory, in particular disclosure requirements, between private and public markets, and the broader impact of private equity on society and the environment. Private equity avoids disclosing information that may benefit competitors as well as investors in public markets. This is of particular significance in relation to intangible assets which relatively uninformed dispersed investors in public markets may find harder to evaluate than more concentrated private investors.

Institutional Investment

Alongside the decline of listed companies in the UK and US, one of the striking features of equity markets is the changing nature of their investors. At the start of the 20th century, individual investors – the fabled "widows and orphans" of capitalism – predominated. By the middle of the 20th century their place had been taken by institutional investors – life insurance companies, mutual funds and pension funds – particularly in the UK and US. They reached their zenith in the 1980s but were then replaced by foreign institutional investors, index funds and hedge funds.

In essence what financial markets did over the last 40 years was precisely what textbook descriptions suggested they should do – diversify and internationalize to take advantage of the associated portfolio benefits. The result has been remarkable benefits for savers in the form of extraordinarily low costs of owning internationally diversified portfolios.

The gains at the savers' end of the investment chain have therefore been immense but this has come at the detriment of the other end – firms – because while 40 years ago institutional investment comprised predominantly domestic, long-term shareholdings, it has become progressively shorter and less connected. What has therefore emerged is a combination of long-term passive shareholdings in the form of index funds and short-term activist hedge funds, leaving a vacuum in the provision of long-term engaged investors.

[27] Peter Morris and Ludovic Phalippou (2020), "Thirty Years After Jensen's Prediction Is Private Equity A Superior Form of Ownership?", *Oxford Review of Economic Policy,* forthcoming.

Many reasons are suggested for this vacuum, in particular a failure in the chain between individual investors and the firms in which they invest. The asset owners (life insurances, mutual funds and pension funds) are regarded as insufficiently informed about the preferences of their savers and engaged with defining the mandates of the funds that manage their portfolios. Instead, asset managers' performance is evaluated on a short-term basis that is reflected in the way in which they scrutinize the performance of the companies in which they invest. The result is a system of ownership that should in principle be focused on the delivery of long-term financial performance but in practice may have done the opposite. As John Armour notes, strengthening shareholder rights might exacerbate rather than alleviate this problem, giving rise to a risk of excessive as well as deficient shareholder rights.[28]

In response there have been calls for greater "stewardship" by institutional investors of their portfolio of investments. What is meant by this is they should act like owners in having regard to the way in which their investments are deployed and engage with the companies in which they invest. As Julian Franks describes, the response has come in two forms.[29] The first is more engagement by institutional investors through expressions of "voice" in meetings with senior management and voting at shareholder meetings, and "exit" by divesting of shares. These engagements are informed by the institutions' corporate governance and sector analyst departments.

What militates against this is the dispersed nature of share ownership in the UK and US, which undermines the incentives of any one investor to incur the costs of active engagement. The second form of engagement is hedge fund activism in which institutions seek to mitigate the free riding problem by buying blocks of shares in companies and, together with other institutional investors, bringing about desired changes in board composition, corporate strategy, financial and investment policy.

More recently there has been a call not just for more but better stewardship in promoting the enlightened shareholder approach mentioned above by which investors take account of the interests of other stakeholders in furthering their own interests and mitigating the risks of their investments. This has a prompted a rapid growth of interest in "sustainable finance" and incorporation of environmental and social factors in investment analysis.

Even were these problems of the investment chain, free-riding and incentives to be addressed, they would still not solve the fundamental problem of trusteeship versus stewardship. Stewardship is about self-interest, albeit enlightened self-interest, as against respecting the intrinsic interests of others in their own right. So long as the interests of owners are perceived to be inherently selfish then others should correctly interpret them as being inauthentic. Their goodwill is only as good as their will.

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[28] John Armour (2020), "Shareholder Rights", *Oxford Review of Economic Policy,* forthcoming, reports evidence of a negative relation between investment in innovation and reliance on share prices as measures of corporate performance.

[29] Julian Franks (2020) *op. cit*.

Frederick Alexander describes how the increasingly global nature of mutual, in particular index, funds provides a potential resolution of this problem.[30] The "universal" nature of these global portfolios by which they essentially hold shares in all stocks around the world mean that their investors are not interested in the performance of individual stocks but in their total portfolios of stocks. The idiosyncratic risks of particular companies are therefore irrelevant and instead it is the global systemic risks of environmental, political, regulatory, social disruptions that are of concern. In other words, universal owners have an interest in the "externalities" that individual companies fail to internalize. They are therefore arguably the appropriate guardians of global systemic risks, a duty that they could discharge by incorporating this trustee role as part of their fiduciary responsibilities.

In contrast to the self-interest of stewardship, trusteeship is concerned with the interests of others. Benevolent though this may be, trusteeship is not business if it does not also align with self-interest. The remarkable feature of trusteeship and the resolution of the problem of translating individual self-interest into collective, cooperative interest in common purposes comes from the fact that trusteeships for others may ultimately be to the benefit of the self as well as the other. Trust-based systems dominate shareholder primacy in terms of commercial as well as societal performance.

Purpose and Performance

The idea that a trust-based system could outperform a shareholder primacy one sounds fanciful. A system with a laser sharp focus on generating returns for their owners would seem to be obviously more efficient than one that tries to balance the interests of many parties in delivering purposes beyond profits. But there are two reasons why this might not be so. The first is the response of the beneficiaries of trust-based firms and the second is the response of the regulators of other firms.

Firms whose ownership and governance demonstrate a commitment to solving problems and not profiting at the expense of others may legitimately be regarded as more trustworthy by the parties with which they transact. Intentional other-regarding preferences instil greater trust than those that are derivative of the promotion of enlightened self-interest. They encourage more loyalty, engagement, reliability and support on the part of customers, employees, suppliers and communities. Trustworthiness then translates into more trust in counterparties resulting in superior firm performance. What the trust-based firm does that even the most enlightened shareholder primacy firm fails to do is to create one of the firm's most valuable assets – its trustworthiness. That is the source of the competitive advantage of trust-based firms and trusteeship systems.

The obvious case within which to test this is firms owned by trusts – the industrial foundations. Research on this concludes that, while their financial performance is approximately the same as that of equivalent matched non-industrial owned firms, there is one respect in which their performance is markedly different – they survive.[31] On average,

[30] Frederick Alexander (2020), "The Benefit Stance: Responsible Ownership in the Twentieth-First Century", *Oxford Review of Economic Policy,* forthcoming.
[31] Steen Thomsen (2018) "Foundation Ownership and Firm Performance: A Review of the International Evidence", in Ciaran Driver and Grahame Thompson (eds) *Corporate Governance in Contention*, Chapter 4, OUP.

the length of life of industrial owned firms is approximately three times that of equivalent firms.

This brings out an important point and that is the traditional way of measuring performance in relation to financial returns – stock market and accounting studies – may tell one little about overall performance. If, for example, sustainability or survivability are regarded as the relevant criteria of performance then industrial foundations outperform other firms.

Even if this is not the case then there is another respect in which trusteeship might matter and that is in relation to the government and regulation. To the extent that shareholder primacy firms benefit at the expense of other parts of society and the environment then revelations of misconduct are likely to be reflected in intensified regulation. So extrinsic regulation and intrinsic trusteeship can be regarded as substitute methods of upholding societal interests and to the extent that the latter is absent then the former might be required. Trust based organizations might therefore benefit from less stringent regulation as well as stronger relationships with their counterparties. On both scores, the observation that trusteeship could demonstrate greater resilience than shareholder primacy might not be as paradoxical as it seems at first sight.

This has particular significance in relation to one important counterparty and owner of many companies – the state.

Public Ownership

An obvious answer to the problem of promoting public interest is public ownership. There are four forms of state ownership: direct holdings by national, regional and local governments; public pension funds; sovereign wealth funds; and holdings by state owned enterprises. The OECD report that 800 of the world's 10,000 largest listed companies have public sector ownership of more than 50% of equity capital, with direct holdings being the largest source, followed by sovereign wealth funds and public pension funds.[32]

The wave of privatisations that emanated from the UK and US in the 1980s was a manifestation of dissatisfaction with public ownership which became commonplace after the Second World War. While in principle the state should be a promoter of the public and social interest, in practice it is subject to distortions of bureaucracy, corruption, lobbying and political opportunism. More significantly in a corporate context, it imposes monism and uniformity of ideas and intentions where pluralism and diversity are desired.

However, the resulting privatisations are now also subject to growing criticism as their professed benefits fail to materialize and the detriments of the private provision of public goods and services become evident. In particular, the mechanism that was supposed to achieve an alignment of private profit with public interest, namely regulation, has been found to be seriously deficient in avoiding abuses of monopoly and promoting efficiency in the

[32] Adriana De La Cruz, Alejandra Medina and Yung Tang (2019), *op. cit.*

delivery of public services. The response to date, alongside the possibility of renationalization, has been a call for better and more intensive enforcement of regulation.

But there is a limit to what regulation can achieve in a context in which there is such divergence of interest between the regulator in public benefit and corporations in the private pursuit of profit.[33] That limitation comes from the ability of private investors to redeploy their capital from locations of intensive regulation. The response to the financial crisis is indicative of that, where initial promises of intense regulation have been progressively diluted as economic and political realities have set in.

We are therefore currently in a limbo between disquiet about public ownership and dissatisfaction with privatisation and regulation. And that is the inevitable consequence of a system that seeks to impose extrinsic forms of social benefit on organizations that are intrinsically self-interested. Instead, what is required is a recognition of the inherent obligation on corporations to promote public as well as private benefit, in particular in circumstances in which they deliver important public functions, such as infrastructure and public service providers, especially in conditions of monopoly, such as utilities. These companies owe a special duty and standard of care to those who they serve. Their commitment to the delivery of their social licences to operate should be intrinsic to their purpose and corporate constitution.

Nowhere is state ownership more in evidence than in China. Curtis Milhaupt reports an OECD study of seven non-member countries which finds that at the end of 2015 “China accounted for over 75% of the 628 listed companies with majority or minority state shareholdings and almost 85 percent of their combined market value of approximately $4 trillion.”[34] It is not just in China that state ownership is important, Curtis Milhaupt reports that it is on the rise around the world – “over the period from 2005 to 2014, the share of SOEs in the Fortune Global 500 increased from 9% to 23% … and as of 2018, there were 107 SOEs in the Fortune Global 500”[35] – the global wave of privatisation has been reversed.

Curtis Milhaupt documents the important lessons that can be learnt from China for state ownership. In particular he notes the role that the corporate form can play in separating business from government. In particular, a combination of state ownership with the listing of companies on stock markets provides a form of mixed ownership equivalent to that of the dual ownership discussed above in relation to listed companies with family or foundation block holders. However, where the block holder is the state then the preservation of independent corporate governance from block holder influence raises particular challenges. In contrast to examples elsewhere, such as the government owned investment management

[33] John Armour (2020), “Shareholder Rights”, *Oxford Review of Economic Policy,* forthcoming, notes that lobbying and political contributions to weaken regulation appear to yield positive returns to shareholders, particularly in regulated and concentrated industries - John Coates (2012), “Corporate Politics, Governance, and Value Before and After Citizens United”, *Journal of Empirical Legal Studies*, 9, 657-696.
[34] Curtis Milhaupt (2020), “The State as Owner – China’s Experience”. *Oxford Review of Economic Policy,* forthcoming, and OECD (2017), “The Size and Sectoral Distribution of State-Owned Enterprises”, available at http://dx.doi.org/10.1787/9789264280663-en.
[35] Curtis Milhaupt, *op. cit.*

firm Temasek in Singapore, the Chinese governments influence on corporate China has intensified not waned over the recent past.

Sovereign wealth funds, such as Temasek, are rising in prominence. They are estimated to hold more than $8 trillion of assets, accounting for about 10% of global assets under management. They are therefore well placed to exercise considerable influence on the conduct of companies for both domestic political motives and more enlightened global environmental and social goals. Hao Liang and Luc Renneboog record that environmental, social and governance considerations feature prominently in their stock selection criteria but not in their corporate engagement.[36] To date therefore sovereign wealth funds have had an effect on equity allocation but not on investor engagement, though there is evidence that some funds, such as the Norges Bank Investment Fund, are devoting increasing attention to engagement as well. This raises the intriguing possibility that public ownership of the future will take the form of block holdings through publicly owned investment management firms rather than outright state ownership to align private with public purpose in global as well as domestic corporations.

Conclusions

Ownership of corporations is not just property. It is trusteeship as well as agency. It is about second party as well as first party interests. But how should this be implemented? What are the public policy instruments that are required to bring it about?

In a major programme on the Future of the Corporation, the British Academy, the UK national academy of the humanities and social sciences, has set out a comprehensive proposal for reform of corporations around the world to address the economic, environmental, political and social challenges they face and to take advantage of the remarkable scientific and technological advances that are in progress for the benefit of humanity.[37]

In addressing this it is important to recognize that this is a systems design issue. We have developed a coherent and consistent notion of capitalism on the basis that it is an economic system of private ownership of the means of production and their operation for profit. In this context, ownership is a bundle of rights over assets that confers strong forms of authority on their possessors. And firms are viewed as nexuses of contracts managed by their boards of directors for the benefit of their owners. In other words, capitalism is private ownership for profit managed by boards that engage others through contracts.

In contrast, the view that is being expressed here is that capitalism is an economic and social system of producing profitable solutions to the problems of people and planet by private and public owners who do not profit from producing problems for people or planet. In this context, ownership is not just a bundle of rights but a set of obligations and responsibilities to uphold the delivery of these purposes. And firms are not just nexuses of contracts but nexuses of relations of trusts based on principles and values enshrined by the boards of

[36] Hao Liang and Luc Renneboog (2020), "The Global Sustainability Footprint of Sovereign Wealth Funds", *Oxford Review of Economic Policy,* forthcoming.
[37] British Academy (2019), *Principles of Purposeful Business: How to Deliver the Framework for the Future of the Corporation,* London: British Academy.

directors. This too is a coherent and consistent view of capitalism in which it is about solving problems by owners and boards who engage with others through relations of trust as well as contracts.

Evolving from one system to the other is a systems design problem. While there are numerous suggestions for reform, there has to date been no comprehensive proposed resolution. The Future of the Corporation attempts to do this around four sets of principles that could be universally adopted to remedy the deficiencies of current arrangements. The first concerns law and regulation; the second ownership and governance; the third measurement and performance; and the fourth finance and investment.

Law and regulation should put purpose at the heart of the fiduciary responsibilities of companies and expect particularly high standards of those that perform important public functions. Measurement and performance should reflect the importance of human, natural and social as well as financial and physical assets, and measure performance in relation to the delivery of corporate purposes. Finance should ensure the provision of adequate long-term risk bearing capital to fund the investments and partnerships that companies need to fulfil their purposes. And this paper has described how ownership and governance lie at the heart of the deficiencies of current arrangements and the need for reform.

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