

Companies, Shareholders and Sustainability



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Executive summary

The coronavirus pandemic exposes many of the shortcomings that characterise the UK's company law and corporate governance system and highlights a need for urgent change. Alongside the pandemic, the world faces the threat of climate change and the actions of corporations will be pivotal to the response to that threat. Yet the corporate governance of many large corporations is focused on short-term strategies to increase share prices and quarterly profit that would maximise the rent that shareholders may extract and these strategies are driven by hedge funds and financial markets, leaving companies stripped of reserves that might buffer them from the economic impact of shocks like the pandemic crisis and threats like climate change.

The pandemic has raised systemic questions around the future design of a corporate governance and legal framework that can deliver robust enough rules to avoid vulnerabilities going forward. It has also created a hiatus with opportunities for reflection on how to rebuild the future of our companies under a welfare paradigm that goes beyond the financial profit and economic growth. This raises the possibility of a new paradigm of sustainability which, while not defined universally, we envisage to include environmental preservation as well as social justice and societal welfare.

This report investigates what a robust governance framework for companies would look like under a sustainability paradigm, and what function company law will have in this. It is clear that as we pursue a sustainability paradigm, shareholders will continue to play an important role in this shift. Not only will they provide finance for companies directly, but they thereby also contribute indirectly to other financial structures that society relies on such as pension income, insurance cover, taxation, investment etc. In choosing options for system change the motives of the shareholders will therefore be central, and the objective of this report involves asking how we can mobilise shareholders in the pursuit of sustainability and their relationship to other actors in corporate governance, including directors, employees and other stakeholders as well as regulators.

The report presents an argument that system change for corporate sustainability requires a departure in some areas of company law from the UK's traditionally non-interventionist and market-based system in favour of a more interventionist approach. It requires an outlook on sustainable companies that, while continuing to be based on pragmatism, flexibility and economic incentives, does also incorporate further company regulation. The report considers the potential of several initiatives to effect change, including the following.

Institutional change: *for directors' behaviour to change in the long term, the derivative action process could be simplified further to increase speed and reduce costs so that shareholders would be more inclined to take action against directors. An enhanced regulatory system, on the other hand, would also include more wide-ranging enforcement measures, some of which would involve other stakeholders, as well as take steps to ensure that shareholders take their responsibilities more seriously.*

Directors' duties: *there is scope for section 172 of the Companies Act 2006 to be reformed, especially in combination with an enhanced regulatory system. A simple change would include more direct reference to future generations of stakeholders which is currently absent. But more comprehensive proposals have been developed to subject directors to a legally binding obligation to develop, disclose and implement, on behalf of the company a forward-looking corporate sustainability strategy.*

Shareholder stewardship: *how we view the role of shareholders in efforts towards achieving corporate sustainability is important. We may, on the one hand, seek to harness their influence in pursuit of sustainability and acknowledge this for a sustainable system. In the UK, the Stewardship Code already requires institutional shareholders to act as*

responsible owners, albeit in a non-binding manner. However, encouraging greater activism by investors on the other hand risks the goal of sustainability being modified to fit with more fundamental investor concerns of maximal dividend returns and capital gains. There is evidence that investors take interest in environmental, social and governance (ESG) issues, but frequently this appears linked to possibilities of continued wealth or as a strategy to avoid risk.

For the purposes of this report, we accept that, given the fact that shareholders are not represented by one homogenous group, there may be different social and psychological differences among their reasons for sustainable investment. As a starting point, we observe leaders and followers among two different categories of shareholder: those that stall or delay the transition towards sustainability ('brakers') and those that drive towards sustainability ('pushers'). The brakers are led by hedge funds and followed often by individual retail investors whose main priority is to receive dividends from profits and increased share value. The pushers are led by investor groups such as those in the UN Principles for Responsible Investment and socially responsible investors as well as campaign shareholders such as those in Share Action, and they are followed by institutional investors who are increasingly seeing that this is the trajectory and so they will support it, often encouraged to do so by their clients.

A reformed legal regime would be required to enhance stewardship substantially, following existing proposals to impose on investors, at every level of the investment chain, legally binding obligations to consider, identify and disclose ESG risks and issues. It would also mean encouraging or imposing voting and shareholding structures that ensure shareholder voice will take account of long-term interests and that good stewardship is both rewarded and reinforced. This also may involve forms of trust or foundation ownership or a restructuring of voting rights.

Governance: going beyond stewardship, we expect other aspects of a reformed corporate governance system to challenge the central position of shareholders in current corporate culture to achieve real sustainability. The existing UK corporate governance framework would need to be altered, with the potential also to impact on companies' transparency in disclosure and reporting obligations. More extensive protection of the environment will also be needed and should be integrated more strongly into the corporate governance structure. This can be achieved by one or a combination of initiatives such as exposing managers to personal risk liability for breach of legal and regulatory requirements aimed at environmental protection, appointment of boardroom members with special mandate for focusing on environmental matters, closer linkage between directors' rewards and environmental performance, introducing jurisdiction for environmental groups and other stakeholders to be able to challenge directors for breach of their duty to promote the success of the company.

Membership: building on the above, there is a case for moving towards a more equalised membership arrangement for stakeholders. The principles of shared or inclusive membership should align with the paradigm of sustainability and should give to those who contribute to the company both a voice and a share in its proceeds.

Transparency: there is need for greater standardisation of legal and governance requirements, disclosure and effective monitoring, including minimum sector-specific requirements. One important change would involve a revision to section 396 of the Companies Act 2006, so that the true and fair view is defined within the Act to include information on the social and environmental impact of the enterprise. Such a change would be consistent with the requirement for directors to show how they have complied with their duty under section 172.

Takeovers: section 172 of the Companies Act 2006 is applicable in a takeover scenario and directors must be mindful of that in their own actions during the process of an acquisition. This could open a door to a more sustainability-oriented takeovers process

and provide the basis of an argument for a more explicit principle to be introduced into the Takeover Code along these lines, e.g. requiring the board of the offeree company, when advising the holders of securities, to give its views on ESG matters including the environment.

Local economies: *these are increasingly recognised as important for achieving sustainability, and there are already positive examples of local networks to give smaller businesses and organisations the space, knowledge and tools to become more sustainable. A key feature is the educational potential of these networks that can help to grow sustainability across the broader economy. These activities include campaigns for reform of company law to take account of new business needs that are compatible with sustainability.*

Introduction

The coronavirus pandemic has been a dramatic shock to the health of the world's population and to the global economy. Over one million people worldwide have now died of COVID-19, and many more millions have contracted the virus, some experiencing mild effects but many others being left with long term damage to their bodies. The economic impact has also been tumultuous, with large and small businesses suffering enormous losses, individuals losing their jobs temporarily and permanently and new ways of working at home have been found, with the aid of digital technology. It is clear now that the pandemic's economic and health impact has not been evenly distributed, with differences apparent not only in terms of access to health care and protection from the virus. In addition, data now shows that some have benefitted tremendously from the pandemic as their corporate shares have soared just as others are facing hardship and loss. Social and economic inequalities, rife before the pandemic struck, have, it seems, been even further accelerated now. Meanwhile, other global challenges continue to develop at pace. The pandemic spread around the world just after news programmes had reported on some enormous environmental disasters: the Australian bushfires, flooding in various parts of the world and locust swarms in East Africa. All these events are related to climate change, an urgent problem that continues to threaten the world, perhaps more devastatingly than the coronavirus.

This report explores the potential contribution of corporations towards achieving greater sustainability and how company law and corporate governance have shaped corporate behaviours. In particular the report, focusing on UK company law, investigates the role that shareholders have played thus far and what they can do in the future. Company law in the UK has allowed corporate actors to have significant freedom, with an emphasis on market discipline that has led to the development of a shareholder primacy approach that emphasises the goal of profit maximisation. Even though directors are required to take account of the interests of other stakeholders when making decisions for the company, in reality those stakeholders have been given little opportunity to influence business strategies. This has resulted in companies externalising their costs and not being held to account for environmental damage or social harms that arise from their activities. Shareholders, whose financial interests have been the principal focus, could use their position to influence more positively how corporations pursue their profits. This report considers how the legal and regulatory framework shapes the behaviours and decisions of shareholders and corporate leaders. Part 1 describes the background context for the report and briefly outlines the new sustainability paradigm we envisage for companies and their shareholders. Part 2 details and evaluates the current framework and identifies that among shareholders there are 'brakers' who slow down progress towards more sustainable business activities and 'pushers' who seek more progressive business behaviours. Part 3 then puts forward suggestions as to how the framework can be reformed in order to support more fully the 'pushers' and contribute to a more sustainable corporate environment.

1. Background: a new sustainability paradigm

The coronavirus pandemic provides a dramatic background context for this report. Back in the spring of 2020, as the world woke up to a pandemic with political leaders facing stark challenges, many corporations and their leaders too were put on the spot. Richard Branson's successful persona as progressive entrepreneur for example took a full-body blow, following his plea to governments to bail out his grounded Virgin Atlantic airlines with millions of pounds of taxpayers' money, offering even his privately owned island as loan collateral.¹ For many, this seemed a testament not of progressive entrepreneurship but of corporate risk-shifting and a shockingly low regard for sustainability in modern day capitalism. No-one would have denied that Virgin group, like many other large companies and conglomerates, was hit hard by the impact of coronavirus, affecting everyone from employees and suppliers, consumers and creditors, to company shareholders whose assets tumbled. Yet while their plea for bailouts implied these were largely inevitable effects of a global catastrophe that corporations could not be expected to shoulder alone, others rejected this angrily. For them, these corporate bailout calls reflected levels of corporate rent-seeking that were perceived as outrageous well before the crisis.² They also saw the contributory role of a corporate governance system that, way before the pandemic hit, lacked proper regard for long-term economic, social and environmental sustainability.³

Instead this system of corporate governance focused on short-term strategies to increase share prices and quarterly profit that would maximise the rent that shareholders would be able to extract from company assets - even if it meant buying back the company's own shares in bulk and avoiding corporate tax.⁴ These strategies, driven by hedge funds and financial markets, left companies stripped of reserves that would have, at least initially, buffered some of the economic impact of the crisis. They may have averted job losses and other existential threats. The pandemic would no doubt hit them hard, but the preceding period of rent-seeking and short-termism left them so vulnerable as to make calls for a life-saving cash injection virtually inevitable. Just as with the banking bailouts following the earlier systemic failures in the global financial crisis of 2008, the economic impact of the pandemic revealed once again a corporate and financial system that by default appears to privatise profit but nationalise risk. It raised urgent questions of whether governments would heed the rent-seekers' call for bailouts readily or adopt a tougher stance this time, at least by seeking long-term control in exchange for financial support. We know, now, that when public rescue packages were indeed secured for several UK airlines in 2020, they came with only few strings attached.⁵

¹ Cao, S. 'Seeking Government Bailout, Virgin's Branson Offers His Private Island as Collateral' *Observer*, 21 April 2020 at <https://observer.com/2020/04/richard-branson-virgin-atlantic-offers-private-island-uk-government-loan/>

² See e.g. Martin Wolf, 'Why rigged capitalism is damaging liberal democracy' *Financial Times*, 18 September 2019 at <https://www.ft.com/content/5a8ab27e-d470-11e9-8367-807ebd53ab77>

³ Ibid.

⁴ <https://www.bbc.co.uk/news/business-51903947>; <https://www.theguardian.com/business/nils-pratley-on-finance/2020/mar/16/coronavirus-points-to-ponder-before-a-bailout-of-airlines#maincontent>; similarly, on the financial sector and the ECB's moratorium on share dividend payments see <https://www.ft.com/content/b5736d97-02c0-4e1f-84c3-a2d192bcc519>.

⁵ See the COVID Corporate Financing Facility at <https://www.bankofengland.co.uk/markets/covid-corporate-financing-facility>. But on Virgin Atlantic's own financing package, see 'Virgin Atlantic secures £1.2bn rescue package to keep flying', *Financial Times*, 14 July 2020, at <https://www.ft.com/content/99d90182-dff3-4638-ba4c-e13ad3686025>.

1.1 Design of sustainable corporate governance

The exposure of these vulnerabilities raises fundamental questions around the future design of a corporate governance and legal framework that can deliver robust enough rules to avoid the same corporate governance failures and disregard for sustainability, going forward. It may be that this pandemic has changed the world, creating either the ‘end of normal’⁶ or a ‘new normal’.⁷ Indeed, already there has been a rush of publications and thought pieces on the effects of the pandemic and on the possible changes that can be made in the longer term.⁸ But what is clear by now is that COVID has presented us not only with extensive social, political and economic challenges but also with opportunities for reflection on how to rebuild the future of our economies and our companies under a welfare paradigm that goes beyond financial profit and economic growth.

Alongside the pandemic, the world of course faces the even greater threat of climate change and the actions of corporations will be pivotal also to the response to that threat. The Sustainable Development Goals (SDGs) have provided a refreshed optimism that business actors can be directed in ways that are more respectful of human rights and sustainability. Already there has been much debate about how these SDGs might be achieved in practice.⁹ We appear at last to have recognised that climate change now presents serious imminent crises across the world.¹⁰ Growing climate rebellion uprisings are forcing us to think about the threats we face and how we all, collectively and as individuals, will need to make significant changes to the ways in which we live.¹¹ At the same time, as economies struggle to grow continually and new ways of working are fast emerging, fresh debates are also developing around sustainability, well-being and social justice.¹² Whether these developments result in concrete and substantial changes for the better depends, to a large extent, on important choices to be made about the future of

⁶ See Stuart Scott, Scientists Warning, ‘The End of Normal’, Part 1’ YouTube, 23 April 2020, at <https://www.youtube.com/watch?v=PlZhQJBZ574>

⁷ Charles Eisenstein, *The Coronation*, March 2020 at https://charleseisenstein.org/essays/the-coronation/?_page=5

⁸ E.g. Martin Parker (ed.), *Life after COVID: the other side of crisis* (Bristol University Press, 2020, forthcoming)

⁹ See eg: Walker, J., Pekmezovic, A., & Walker, G. (2019) *Sustainable Development Goals: Harnessing Business to Achieve the SDGs through Finance, Technology and Law Reform* (John Wiley & Sons); Deacon, B. ‘SDGs, Agenda 2030 and the prospects for transformative social policy and social development’, (2016)

Journal of International and Comparative Social Policy, Volume 32, 2016 - Issue 2: 79-82; Sakiko Fukuda-Parr (2016) ‘From the Millennium Development Goals to the Sustainable Development Goals: shifts in purpose, concept, and politics of global goal setting for development’, *Gender & Development*, 24:1, 43-52; The World in 2050 (TWI2050) ‘Transformations to Achieve the Sustainable Development Goals’ (2018) United Nations; Oliver Cann, How can the Development Goals Be Achieved? (World Economic Forum, 23 September 2018); UN Global Compact, How your company can advance each of the SDGs, undated at <https://www.unglobalcompact.org/sdgs/17-global-goals>

¹⁰ William J Ripple, Christopher Wolf, Thomas M Newsome, Phoebe Barnard, William R Moomaw, World Scientists’ Warning of a Climate Emergency, *BioScience*, 5 November 2019; Jordan Davidson, The Federal Reserve Finally Talks About the Climate Crisis, *Ecowatch* 11 November 2019, at <https://www.ecowatch.com/federal-reserve-climate-crisis-2641307182.html>

¹¹ The Greta Thunberg effect is now widespread.

¹² See eg Richard B Howarth, Sustainability, Well Being, and Economic Growth, *Minding Nature* (2012) 5:2, 32; Jason Hamilton and Thomas J Pfaff, Social Justice and Sustainability: Two Perspectives on the Same System in Karaali G. and Khajavi L S (eds) *Mathematics for Social Justice: Resources for the College Classroom* (2019): 33; Eizenberg, E., & Jabareen, Y. (2017). Social sustainability: A new conceptual framework. *Sustainability*, 9(1), 68.

the system of company law and corporate governance that oversees the behaviour of corporations.

As they were after the industrial revolution and in the pursuit of economic prosperity, companies are going to be central also to the quest for sustainable development. While we can see that across the globe extreme poverty has been reduced, this is not the case everywhere, and there is disagreement among scholars on the extent to which multinational companies (including those operating in the UK) have exacerbated or eradicated poverty levels.¹³ More people today enjoy benefits provided by technological innovations sponsored through adoption of the corporate format and reliance upon shareholder capital. But again, some argue that these advances are due chiefly to high initial levels of public funding in research and development, and an entrepreneurial state without which such levels of progress would not have been possible.¹⁴ The ongoing climate emergency and impact of the pandemic, and the urgency of solutions they require demand that the original system paradigm of destination welfare requires some adjustment.

1.2 A new economic paradigm for corporations

The new paradigm we seek is one of sustainability which, while not defined universally, we envisage to include environmental preservation as well as social justice and societal welfare.¹⁵ Sustainability in this sense is not fundamentally a new concern; historical accounts trace ideas of sustainable organising from pre-modernity through the enlightenment and industrial revolution.¹⁶ But it imposes on social, political and economic institutions an expectation of sustainable development as meeting ‘the needs of the present without compromising the ability of future generations to meet their own needs’.¹⁷ This includes a degree of societal scrutiny and democratic accountability of their decisions.¹⁸ It requires social and societal, economic and environmental standards to reflect the insight that individual and collective welfare relies on these standards in both the physical and political environment.

Alternative economic pathways are being developed that address some of these problems and tensions, including among them Kate Raworth’s *Doughnut Economics* (2017: Random House) which explores the economic possibilities of living within the planetary boundaries, and Banerjee and Duflo’s *Good Economics for Hard Times* (2019: Penguin), which seeks to show how problems such as poverty and inequality can be tackled with inclusive and compassionate economic solutions. Another possible starting position might be to move away from the primary economic goal of growth, as expounded in E.M Schumacher’s *Small*

¹³ For critical discussion see eg Giuliani, E. (2018) ‘Why multinational enterprises may be causing more inequality than we think’ *Multinational Business Review*, 27(3), 221-225; Hill, R. P., & Rapp, J. M. (2009) ‘Globalization and Poverty: Oxymoron or New Possibilities?’ *Journal of business ethics*, 85(1), 39-47. Again, though, plenty will argue that corporations have helped to eradicate poverty: e.g. Micklethwait, J., & Wooldridge, A. (2001) ‘The globalization backlash’ *Foreign Policy*, 16-26; van Tulder, ‘The Role of Business in Poverty Reduction towards a Sustainable Corporate Story?’ (UNRISD, 2009).

¹⁴ Mariana Mazzucato, *The Entrepreneurial State* (Anthem, 2013)

¹⁵ See further the chapters by Boeger, and by Villiers and Tsagas, in Novitz and Pieraccini, *Legal Perspectives on Sustainability* (Bristol University/Policy Press, 2020).

¹⁶ Du Pisani, J. (2006) ‘Sustainable development - historical roots of the concept’, *Environmental Science*, 3(2): 83-96; Caradonna, J. (2014) *Sustainability: A History*, (Oxford: Oxford University Press).

¹⁷ World Commission and Environment and Development: *Our Common Future: The Brundtland Report* (1987) Chapter 2: ‘Towards Sustainable Development’ (Oxford: Oxford University Press, 1987).

¹⁸ See <https://sustainabledevelopment.un.org/>

is *Beautiful* (dating back to 1973: Blond & Briggs). Connected to this might also be the size of corporations, as researchers have found that some smaller companies operate more responsibly than large companies, seemingly because they are more proximately close to their stakeholders and therefore are more willing to act on their CSR claims in order to gain the acceptance of those stakeholders.¹⁹ A related observation is that small, innovative firms are often more prepared to change and operate sustainably than large firms.²⁰

A new paradigm of sustainability centres on the commitment to generate sustainable value for social and societal, environmental and long-term economic welfare.²¹ Under this system, economic growth continues to serve as an instrument for value-creation but it no longer is the sole or primary objective. Instead it serves the wider systemic objective of attaining sustainable value for long-term economic, environmental, social and societal welfare. That is not to say growth becomes irrelevant, but rather that, as economist Kate Raworth puts it, we become ‘agnostic’ to it.²² Raworth urges us in her book, *Doughnut Economics*, to shift our focus to ‘explore how economies that are currently financially, politically and socially addicted to growth could learn to live with or without it.’²³ Her proposed agnosticism is to think about ‘designing an economy that promotes human prosperity whether GDP is going up, down or holding steady.’²⁴ One of the consequences of such a shift is the re-politicisation of the question what it means to generate value. While the paradigm of economic growth relies predominantly on financial indicators of welfare, the new paradigm requires political contestation and the balancing of values that are far from ‘unidirectional’.²⁵ Some would see this as a disadvantage because it introduces complexity, others would view it positively as a system that incorporates political reflection on what society values.²⁶

Given this shift, company law and corporate governance can no longer be defined by the assumption that companies exist for the purpose of making profit to provide financial welfare for all. Nor is it possible to maintain the assumption that companies are governed for shareholders’ financial benefit - as mechanisms for them to minimise risk, enjoy the reward of profits and contribute to growth - without questioning also how the mechanism of the company generates sustainable value for stakeholders and society more widely. The priority afforded to shareholders as financial beneficiaries in this system is, then, no

¹⁹ Christopher Wickert et al., ‘Walking and Talking Corporate Social Responsibility: Implications of Firm Size and Organizational Cost’ (2016) 53/7 *Journal of Management Studies* 1169-1196.

²⁰ Anton Shevchenko et al., ‘Why Firms Delay Reaching True Sustainability’, (2016) 53/5 *Journal of Management Studies* 911-935.

²¹ For discussion see e.g. Jackson, T. (2011) *Prosperity without Growth*, Abingdon: Routledge; Harrison, N. (2014) *Sustainable Capitalism and the Pursuit of Well-Being*, Abingdon: Routledge; Ikerd, J. (2005) *Sustainable Capitalism: A Matter of Common Sense*, Boulder: Lynne Rienner Publishers.

²² Kate Raworth, *Doughnut Economics: Seven Ways to Think Like a 21st-Century Economist* (Random House, 2018) especially chapter 7.

²³ *Ibid.*, at 30

²⁴ *Ibid.*, at 245.

²⁵ M Pieraccini and T Novitz, *Legal Perspectives on Sustainability* (Bristol University Press, 2020), Chapter 2

²⁶ Mariana Mazzucato, *The Value of Everything: Making and Taking in the Global Economy* (Allen Lane, 2018); Ratner, B. (2004) ‘“Sustainability” as a Dialogue of Values: Challenges to the Sociology of Development’, *Sociological Inquiry*, 74(1): 50 - 69. M Pieraccini and T Novitz, *Legal Perspectives on Sustainability* (Bristol University Press, 2020), Chapter 2.

longer self-evident, nor is the presumption that the primary motivation of all shareholders is to seek profit. Under a new sustainability paradigm, the assessment of companies' performance is likely to be more complex, at least initially, with requirements for new indicators and methods including on environmental, social and governance (ESG) factors compared to the rather linear financial performance indicators that currently dominate. And while some will see this as a disadvantage and transaction cost, others will observe that there are promising signs in the application of ESG indicators in the context e.g. of non-financial reporting and also with the advent of international sustainable development goals in 2015, providing an initial frame.²⁷

1.3 The role of shareholders

Clearly, as we pursue a sustainability paradigm, shareholders will continue to play an important role in this shift. Not only will they provide finance for companies directly, but they thereby also contribute indirectly to other financial structures that society relies on such as pension income, insurance cover, taxation, investment etc. There is now increasingly widespread indication that in addition to securing economic wealth (profit) investors are concerned also with ESG issues and sustainability,²⁸ especially if they see this as a strategy to avoid risk and increase their wealth prospects further. In choosing options for system change the motives of the shareholders will therefore be central. Key questions include: to what extent can shareholders be relied upon to play an active role in the transition towards sustainability? What are and what will the shareholders' priorities be?

This report investigates what a robust governance framework for companies will look like under a sustainability paradigm, and what function company law will have in this. This involves asking how we can mobilise shareholders in the pursuit of sustainability and their relationship to other actors in corporate governance, including directors, employees and other stakeholders as well as regulators. It also requires us to decide the level and extent of change we require of companies. We must ascertain what our companies will look like in a sustainable world and ask if the changes needed will necessitate collectively enforced decisions or if we can leave such decisions to be realised through market mechanisms. The report discusses the British system of corporate governance and company law where our expertise lies. But we consider that both our analysis and conclusions will also apply to other jurisdictions as these issues are global. Our aim is to identify options for systemic change towards sustainability, in the British system and beyond. Part 2 outlines the UK's current company law and corporate governance framework where sustainability still plays only a secondary role while the focus remains, legally and culturally, on the interest of shareholders, on shareholder wealth and the maximisation of profit. Part 3 investigates the practical implementation of a new paradigm of corporate sustainability in Britain, and especially what role shareholders will play in this shift.

²⁷ See <https://sustainabledevelopment.un.org/>

²⁸ There is evidence of growing membership of the UN PRI: membership had grown to more than 2250 signatories by 2019: <https://www.unpri.org/pri> See also Letter of Larry Fink, Blackrock, 1 February 2016, to S&P 500 CEOs, urging a long term perspective. And calls from large companies for post-COVID 'green and inclusive' recovery: <https://www.businessgreen.com/news/4014829/french-corporates-green-inclusive-recovery>

2. Shareholders in UK corporate governance

Across the world, countries have adopted the corporate form, and company law and corporate governance requirements, similar to those in the UK. It is a system largely designed to be facilitative and pragmatic, supporting business activities rather than being too interventionist or intrusive. In substance, it is based on two key assumptions. The first considers that companies exist for the purpose of making profit that will provide financial welfare for all. The second is that shareholders retain residual property rights in the company (especially the right to receive a dividend and to appoint the board) that enable them to ensure that companies are run in their interests.²⁹ This may not amount to full legal ownership, but shareholders are, in some crucial respects, treated like owners of the company.³⁰

The intention is for this system to provide welfare based on economic prosperity and growth, with companies as the mechanisms by which shareholders minimise their risk and enjoy the reward of profits and contribute to growth. This approach prioritises shareholders even if it does not afford them absolute primacy. Issues of sustainability including environmental, social and societal welfare receive some recognition but largely as an incidental or secondary concern. The framework relies instead on a separate system of external regulation to police the boundaries of corporate action where necessary (setting the “rules of the game”). Issues requiring political intervention beyond the pursuit of shareholder wealth are primarily addressed by way of regulatory intervention, such as through environmental and labour standards, rather than in company law and corporate governance.

That said, the UK company law system does provide flexibility in law for company directors to consider stakeholders other than shareholders and their (short-term) financial interests in their decision-making. We can see this in the core provisions on company directors’ legal duties which, like much of the UK’s company law, can be found in the Companies Act 2006 (the Act). As the name suggests, this statute applies to all companies - large, small, public and private. It is supplemented by a vast body of case law that helps us to understand how the legislation should be interpreted.

2.1. Enlightened shareholder value

Companies are led by directors as their key decision-makers. As the law considers the company to be a legal person in its own right, duties are placed on directors to ensure they act in their company’s interests and not their own. These are now codified in sections 170-177 of the Act, but we still use prior case law to help interpret these duties. The Act is clear that the duties contained in the Act ‘are owed by a director of a company to the company’.³¹ The difficulty arises when we try to define what the interests of a company might be. Section 172 is the most relevant duty in the Act in setting out the interests that

²⁹ Ireland, Paddy (1999) ‘Company Law and the Myth of Shareholder Ownership’, *Modern Law Review*, 62(1) 32-57

³⁰ There are still many (economists and lawyers) who assume the shareholders as owners. See e.g. discussion in Grantham, R. (1998) ‘The doctrinal basis of the rights of company shareholders’ *The Cambridge Law Journal*, 57(3), 554-588; and see also Sun, Y. (2019, December) ‘Investor Relations, Ownership Concentration, and Company Profitability’, *5th International Conference on Economics, Management, Law and Education* (EMLE 2019; Atlantis Press) pp. 362-369

³¹ See section 170(1) of the Act

a director must consider.³² Often discussed as representing an ‘enlightened shareholder value’ approach, this provision requires the directors to promote the success of the company for the benefit of the members as a whole (i.e. all the shareholders), having regard to a range of constituent interests, such as the employees and suppliers.

Section 172 divides opinion. On the one hand, clearly this provision gives some recognition to ESG issues and by extension to sustainability.³³ By requiring them to ‘have regard’ to various interests, it does make clear that the shareholders are not the only focus for directors. Section 172 therefore provides a starting point towards more long-term and stakeholder-oriented behaviours and decisions. There is potential for a more progressive interpretation of the section in light of discussions on trust, culture, and purpose,³⁴ and recognising also that there is increasing attention to business and human rights and impact of business in environment and climate change.³⁵

The section has on the other hand been criticised as too vague and deferential to the idea of shareholder value.³⁶ Labour law scholars in particular have called out section 172 as being harmful to the interests of labour as ‘employees’ are listed as one of a number of stakeholder groups. It has also been described as doing ‘little more than set out the pre-existing law on the subject’,³⁷ and this is reinforced by the somewhat weak requirement to ‘have regard to’ other matters including, for example, sustainability. The provision might even be seen as regressive because the predecessor section (in the Companies Act 1985) and the underlying case law make clear that directors owe duties to the *company*

³² Section 172(1) provides that ‘A 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 benefit of its members as a whole, and in doing so have regard (amongst other matters) to –

- (a) the likely consequences of any decision in the long term,
 - (b) the interests of the company's employees,
 - (c) the need to foster the company's business relationships with suppliers, customers and others,
 - (d) the impact of the company's operations on the community and the environment,
 - (e) the desirability of the company maintaining a reputation for high standards of business conduct, and
 - (f) the need to act fairly as between members of the company.’
- Members means shareholders in this context.

³³ See, for example, Beate Sjøfjell, ‘Dismantling the Legal Myth of Shareholder Primacy: The Corporation as Sustainable market Actor’ in Boeger N. and Villiers C. (eds) *Shaping the Corporate Landscape* (2018) 77-94.

³⁴ GC 100, *Guidance on Directors’ Duties: Section 172 and Stakeholder Considerations*, October 2018. Note that the GC 100 is the GC100 group of the largest listed companies (FTSE100 General Counsels and Company Secretaries). See Villiers C ‘Trust, corporate culture and purpose: section 172 of the Companies Act 2006 in uncertain times’ (forthcoming).

³⁵ See eg Sjøfjell, B. and Bruner, C. (eds) *Cambridge Handbook on Company Law and Sustainability* (CUP, 2020)

³⁶ Lord Wedderburn of Charlton, ‘Employees, Partnership and Company Law’ (2002) 31 (2) *Industrial Law Journal* 103.

³⁷ *West Coast Capital (Lios) Limited v Dobbie Garden Centres Plc* [2008] CSOH 72 at [21]; A. Keay, ‘Risk, shareholder pressure and short-termism in financial institutions: does enlightened shareholder value offer a panacea?’ (2011) 5 (6) *Law and Financial Markets Review* 435 at 443.

and not members.³⁸ This response also reflects the problems we find when it comes to enforcing section 172. Any breach of duty by a director can only be enforced by the company to whom the duty is owed (in practice the other board directors acting on behalf of the company to sue) or by a shareholder in what is called a derivative claim.³⁹

These factors, and the vague framing of the stakeholders' interests in section 172, mean that in UK company law, the company's interests are in practice often equated with the interests of shareholders. In other words, because the law is not currently sufficiently precise or comprehensive in defining what it means to act in a *company's* interests, the concerns of financial investors often prevail. This structure enables financial markets to dominate the behaviours of decision makers and policies of regulators in practice, even in situations where the law does not strictly require it.

2.2. The corporate governance framework

Like other systems around the world, the UK company law system has faced pressure to adapt to global financial markets and the drive for short-term profits from activist shareholders and hedge funds. These can be seen in the Act itself and its interpretation, but also in the operation of various non-binding *codes* that supplement the Act. The principles-based application of these instruments is characteristic of the British corporate governance framework. Companies are expected to comply with the relevant principles in these codes but have some flexibility in choosing how to do this. Enforcement mechanisms are primarily based on soft law and a consensual regulatory approach although the operation of a 'comply or explain' and 'apply and explain' mechanism, and the interaction with listings rules and company law respectively, put additional pressure on companies.

The codes' oversight structures reflect the powerful influence of financial interests in the UK framework. They are published and overseen not by governmental agencies but by regulators that have growing out of financial industry and accounting bodies. The City Code on Takeovers and Mergers, the oldest code in operation dating back to the 1960s, is overseen by an independent City-based Panel on Takeovers and Mergers. Its central objective is to ensure fair treatment for all shareholders in a takeover bid (see further below).⁴⁰ The introduction in the 1990s of the UK Corporate Governance Code saw this approach extended to guide the corporate governance of UK listed companies.

2.2.1 The UK Corporate Governance Code

There are currently over 2,000 UK companies listed on the London Stock Exchange. To register a "premium" listing of their equity (inclusion in FTSE), these companies are required under the UK Listing Rules to report in their annual report and accounts on how they have applied the Corporate Governance Code. The Code is not binding, but its principles apply on a 'comply or explain' basis: to the extent that companies decide not to comply with the relevant governance principles, they are expected to disclose and provide detailed explanations for their derogations.⁴¹ The Code does not apply to private

³⁸ The closest we come to section 172 in the predecessor Companies Act 1985 is a provision stating: '(1) The matters to which the directors of a company are to have regard in the performance of their functions include the interests of the company's employees in general, as well as the interests of its members. (2) Accordingly, the duty imposed by this section on the directors is owed by them to the company (and the company alone) and is enforceable in the same way as any other fiduciary duty owed to a company by its directors.' See Section 309 Companies Act 1985.

³⁹ Section 260(1) Companies Act 2006.

⁴⁰ See <http://www.thetakeoverpanel.org.uk/>

⁴¹ On the de facto application of the Code, see Moore, Marc (2009). "Whispering Sweet Nothings": The Limitations of Informal Conformance in UK Corporate Governance', *Journal of Corporate Law Studies* 9: 95-138.

companies, but a set of similar governance principles have, more recently, been developed for large private companies.⁴²

The Code, in operation, with several iterations, since 1992, is widely seen as an instrument to benefit shareholders by committing the board of directors to a set of governance principles in their interest. Drafted to achieve ‘high levels of transparency’ and ‘improved levels of trust’, its primary aim is to allow investors ‘to take a more considered view of the governance of the company’ and its profitability.⁴³ The most recent version of the Code (2018), however, incorporates a slightly wider focus, including on ESG issues and, by extension, sustainability. It places greater emphasis on relationships between companies, shareholders and stakeholders, and promotes the importance of establishing a corporate culture that is aligned with the company purpose, business strategy, promotes integrity and values diversity. The Code now describes the board’s role in promoting ‘the long-term sustainable success of the company, generating value for shareholders and contributing to wider society.’⁴⁴ In practice, it remains to be seen to what extent this will impact the practical conduct of listed companies.

An area currently of interest is the engagement with stakeholders by company boards. The revised Code contains a reference to the need to engage stakeholders, in particular the employees, and to give to them limited rights to representation in the company’s decision-making structure.⁴⁵ It leaves companies the options of appointing employee directors, of a non-executive director representing employee interests or of establishing an employee committee. Most companies covered by the Code have opted for a non-executive board representative.⁴⁶

While these provisions indicate progress, some see them as disappointing but not surprising after a lack-lustre Government Response in August 2017 to the inquiry launched by the House of Commons Committee of the Department for Business, Energy and Industrial Strategy and the Green Paper on Corporate Governance Reform in November 2016. Despite a busy schedule with Brexit and a slimmed down Queen’s Speech, the Government continues to pursue its plans for corporate governance reform but they were much watered down from the initial signals that had been made to introduce stakeholder representation in boardrooms and to strengthen rules on executive pay that would put pressure on so called ‘fat cat salaries’ by increasing transparency on pay ratios and

⁴² Wates Corporate Governance Principles for Large Private Companies, December 2018 available at <https://www.wates.co.uk/wp-content/uploads/2018/12/Wates-Corporate-Governance-Screen-2018-2.pdf>

⁴³ See Financial Reporting Council, <https://www.frc.org.uk/directors/corporate-governance-and-stewardship/uk-corporate-governance-code>

⁴⁴ UK Corporate Governance Code 2018, <https://www.frc.org.uk/getattachment/88bd8c45-50ea-4841-95b0-d2f4f48069a2/2018-UK-Corporate-Governance-Code-FINAL.pdf>, p. 4, principle 1.A

⁴⁵ UK Corporate Governance Code 2018, <https://www.frc.org.uk/getattachment/88bd8c45-50ea-4841-95b0-d2f4f48069a2/2018-UK-Corporate-Governance-Code-FINAL.pdf>, p. 5

⁴⁶ See Cahill, H. ‘Workers’ on boards are City bigwigs: Government’s flagship business policy in tatters as we reveal how big firms make a mockery of idea’ *This is money*, 18 May 2019 available at <https://www.thisismoney.co.uk/money/news/article-7044247/Government-bid-workers-company-boards-tatters-big-firms-make-mockery-idea.html> cited in Villiers, C, ‘Corporate Governance, Employee Voice and the Interests of Employees: The Broken Promise of a ‘World Leading Package of Corporate Reforms’’ (2020) 49 ILJ forthcoming.

bonuses and give greater effect to shareholders' votes on executive pay. The eventual response and later reforms turned out to be not so far reaching.⁴⁷

2.2.2 The UK Stewardship Code

Supplementing the Corporate Governance Code, the UK Stewardship Code, first published in 2012 and now in its 2020 iteration, applies to institutional investors in UK listed companies. Like the general Code, it sets out broad principles for investor behaviour. Stewardship for this purpose is understood as 'the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society.'⁴⁸ The Stewardship Code is also non-binding but operates on an 'apply and explain' basis: application of the Code's principles is assumed, and investors are expected to disclose an explanation of their practices and progress in implementing them.⁴⁹ These explanations are expected in a Stewardship Report that investors are required to submit to regulators annually.

ESG concerns do feature in the Stewardship Code. Principle 7, for example, states that signatories to the Code 'systematically integrate stewardship and investment, including material environmental, social and governance issues, and climate change, to fulfil their responsibilities.' Its corresponding outcome is that they 'should explain how information gathered through stewardship has informed acquisition, monitoring and exit decisions, either directly or on their behalf, and with reference to how they have best served clients and/or beneficiaries.'⁵⁰ This shift towards inclusion of ESG issues in investment decisions in Principle 7, reflects, arguably, growing support for the notion that institutional investors have fiduciary duties and that these fiduciary duties need not be interpreted from a narrow short-term financial risk and return perspective but could include longer term and wider ESG horizons.⁵¹

But even this latest and substantially revised version of the Stewardship Code is relatively weak on issues of sustainability. In truth, whilst the 2020 Stewardship Code has progressed from its earlier versions, it adheres still to a shareholder-centred paradigm of corporate governance and leaves in the discretion of the institutional investors, what they will report on their investment decisions and the influence that ESG issues might have had,

⁴⁷ For details see Villiers, C. (2017) 'Half-hearted, half-baked and stuck in the rut of business as usual: The Government's Response to the Green Paper Consultation on Corporate Governance Reform' *University of Bristol Law School Blog*, 1 September 2017, at <https://legalresearch.blogs.bris.ac.uk/2017/09/half-hearted-half-baked-and-stuck-in-the-rut-of-business-as-usual-the-governments-response-to-the-green-paper-consultation-on-corporate-governance-reform/>

⁴⁸ The UK Stewardship Code 2020, p. 4, <https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code-Dec-19-Final-Corrected.pdf>. See also <https://www.frc.org.uk/investors/uk-stewardship-code>

⁴⁹ The Stewardship Code 2020, <https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code-Dec-19-Final-Corrected.pdf>

⁵⁰ See also Principle 1 which states that 'Signatories' purpose, investment beliefs, strategy, and culture enable stewardship that creates long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society' with a corresponding outcome that 'Signatories should disclose how their purpose and investment beliefs have guided their stewardship, investment strategy and decision-making; and an assessment of how effective they have been in serving the best interests of clients and beneficiaries.'

⁵¹ See the Fiduciary Duty in the 21st Century Project, at <https://www.fiduciaryduty21.org/country-roadmaps.html> and discussed in Tomlinson, B. 'Sustainability and Fiduciary Duties in the UK: Legal Analysis, Investor Processes and Policy Recommendations', *Oxford Business Law Blogs*, 13 February 2017, at <https://www.law.ox.ac.uk/business-law-blog/blog/2017/02/sustainability-and-fiduciary-duties-uk-legal-analysis-investor>

allowing them to meet the expectations in a way that is aligned with their own business model and strategy.⁵² Evidence suggests that many investors are reluctant stewards. Institutional investors mostly do take an interest in corporate governance issues and seek to monitor boardrooms,⁵³ adopting an owner identity.⁵⁴ However, frequently, shareholders will opt to sell their shares rather than engage and seek to influence the decision-making in the companies in which they invest.⁵⁵ Legally and culturally, not all investors can currently be seen as reliable stewards for a sustainable corporate system (see also 3.3 below).

2.2.3 The Financial Reporting Council and its future

The pragmatic character of the Codes is evident not only in their flexible application but also their regulatory structure which draws heavily on private expertise within the financial and investment industries. Both the general Code and the Stewardship Code are published and (still) overseen by the Financial Reporting Council (FRC). The FRC has the main regulatory role over corporate governance in conjunction with the Financial Conduct Authority, a public agency that oversees the UK Listing Rules, and the London Stock Exchange which is itself a public listed company. Having grown out of financial industry and accounting regulators, the FRC's oversight is primarily focused on financial governance. It is less concerned with ESG activities, unlike some other regulators in the UK, for examples those in the utilities sector.⁵⁶ Indeed, prudent corporate governance in the UK is based ideologically on giving shareholders *more* say in the running of companies, a model which is gaining traction elsewhere.⁵⁷ Such a move is not without its critics who maintain that the dominance of shareholder interests has led to unsustainable business practices in the first place and so increasing shareholder voice in this way is misguided (discussed further below).⁵⁸

How this position might be affected by recent moves from the UK government, following an independent review process in 2018,⁵⁹ to replace the FRC in the near future with a new

⁵² Hamaker-Taylor, R. 'New UK Stewardship Code Requires Reporting On ESG Factors Including Climate Change', *Acclimatise News*, 27 November 2019, at <https://www.acclimatise.uk.com/2019/11/27/new-uk-stewardship-code-requires-reporting-on-esg-factors-including-climate-change/>

⁵³ See eg Association of British Insurers, *Improving Corporate Governance and Shareholder Engagement* (2013) at <https://www.ivis.co.uk/media/5929/ABI-Report-Improving-Corporate-Governance-and-Shareholder-Engagement.pdf>

⁵⁴ McNulty T. and Nordberg D. Ownership, 'Activism and Engagement: Institutional Investors as Active Owners' (2016) *Corporate Governance: An International Review* 24(3) 346-358.

⁵⁵ Ahern, D. (2018) 'The Mythical Value of Voice and Stewardship in the EU Directive on Long-term Shareholder Engagement: Rights Do Not an Engaged Shareholder Make' *Cambridge Yearbook of European Legal Studies*, 20, 88-115., at 112; Cf Jahnke, Patrick, 'Voice versus Exit: The Causes and Consequence of Increasing Shareholder Concentration' (September 18, 2017). Available at SSRN: <https://ssrn.com/abstract=3027058>

⁵⁶ For example, OfWat, OfGem, OfCom sometimes deliver opinions on consumer impacts which have relevance to ESG issues.

⁵⁷ See, for example, the EU's Second Shareholder Rights Directive (Directive 2017/828/EU amending Directive 2007/36/EC).

⁵⁸ L. Talbot, 'Why Shareholders Shouldn't Vote: A Marxist-progressive Critique of Shareholder Empowerment' (2013) 76 (5) *Modern Law Review* 791.

⁵⁹ The recent Kingman Review: *Independent Review of the Financial Reporting Council*, (DBEIS, December 2018); see also connected reviews: Brydon Review, *The quality and effectiveness of audit: independent review* (2019) and Competition and Markets Authority, *Statutory Audit Services Market Study: Final Report*, (April 2019).

regulatory agency named as the Audit, Reporting and Governance Authority (ARGA), remains to be seen. While little yet is known about the details of ARGA's substantive remit and constitutional structure⁶⁰, it has been outlined by the UK Department for Business, Energy and Industrial Strategy as a *statutory* body with powers to direct changes to company accounts and to conduct more comprehensive and visible reviews for greater transparency than are currently feasible for the FRC. Envisaged are, further, additional powers to regulate the largest independent audit firms directly and, more generally, to impose greater sanctions in cases of corporate failure, including new powers to require rapid explanations from companies or, in the most serious cases, publish a report about the company's conduct and management.⁶¹

2.3. Shareholder voice

Both the company law and corporate governance framework, as we have seen, rely on shareholders to hold company directors to account for their decisions. In this, the company law system is organised around an assumption that all shareholders seek profit and the performance measures on which directors are mostly judged revolve around short-term profit maximisation as reflected in share prices. This is not what the law strictly requires (see above) but is assumed to reflect investor motivations and arguably those of directors whose remuneration is linked to share price. The relevant tools available to shareholders within existing company law to exercise these governance rights are formulated without giving explicit thought to issues of sustainability or interests of other stakeholders. Shareholders may of course use their voice to promote ESG issues in the firm, based e.g. on the company's reporting and disclosure documents (see below), but they are not required by law to do so.

2.3.1 Voting rights

In a simple company, there may be only one class of shareholder (ordinary shares) but in more complex companies, different classes or categories of shareholders will exist with different rights. The starting point is that each shareholder carries one vote per share and this gives to them considerable decision-making power and an ability to hold the directors to account, including appointing and dismissing directors.⁶²

2.3.2 Annual general meeting (AGM)

The key forum in which directors are required to answer for their decisions and where shareholders are given the power to ask the questions. They may also call special meetings and put forward proposed resolutions if they meet the conditions for doing so. A recent review of the 2019 AGM season shows a continued trend from previous years of the majority of shares being voted (75% in FTSE100 companies and 77% in FTSE250 companies) with overwhelming agreement with the resolutions being proposed by the company.⁶³

2.3.3 Derivative claims

If given permission by the court, the shareholders are able to take action against directors on the company's behalf. These are infrequently used. They are time-consuming, complex and costly. When weighing up whether to grant permission for a shareholder to sue, the court will also take into account the likelihood of any alleged breach or negligence being

⁶⁰ Progress appears to have slowed during 2020 as a result of Brexit and the Covid-19 pandemic.

⁶¹ See the Department for Business, Energy and Industrial Strategy at <https://www.gov.uk/government/news/audit-regime-in-the-uk-to-be-transformed-with-new-regulator>.

⁶² Shareholders can dismiss a director with a simple majority vote - section 168 Companies Act 2006.

⁶³ KPMG Makinson Cowell, *Review of the 2019 AGM season*, January 2020 at 5 available at: <https://assets.kpmg/content/dam/kpmg/uk/pdf/2020/01/review-of-the-2019-agm-season-january-2020.pdf>

ratified i.e. approved internally by shareholders. If the issue can be ‘cured’ internally, the courts will be reluctant to tie up judicial resources in permitting a derivative claim to proceed.⁶⁴ In his review of the first 8 years of the new statutory scheme up to September 2015, Professor Andrew Keay found only 22 instances of claims being instigated across all of Scotland, Northern Ireland, England and Wales.⁶⁵

2.3.4 Informal communications

Directors and institutional investors often meet behind closed doors and it is thought that these investors have strong lobbying powers to obtain what they want from the directors.⁶⁶ Evidence indicates that institutional investors frequently have successful private discussions⁶⁷ with boardrooms and this enhances their loyalty to the company, encouraging them to exercise their voice rather than rush to exit⁶⁸ and take their investments away. Whilst this raises potential corporate governance problems such as privileged access to information and possibilities of insider dealing, it does strengthen the argument for developing more effective investor stewardship, especially for institutional investors, who are less dispersed than other shareholders and they are more likely to adopt a longer term view than some shareholders such as hedge funds, who tend to be more aggressive and short-term oriented in their activism. The stewardship approach, together with the concept of universal ownership, provide a potential basis for institutional investors to consider more concretely a sustainability agenda, as we are seeing in countries like Norway, where pension funds are pursuing sustainability goals in their discussions with boardrooms.⁶⁹ On the other hand, there is a tension between this approach and the increasing calls from some campaigners to reduce shareholder influence.⁷⁰

2.4. Disclosure and reporting obligations

To be able to exercise their governance rights in the company, shareholders require information about the companies they invest in. A further important aspect of UK company law therefore, which ensures that such information is forthcoming and comprehensive, are the disclosure and reporting requirements set out in domestic, European and international legislation. Disclosure laws are most developed for financial reporting but increasingly, non-financial reporting has gained salience. Disclosure and due diligence laws relevant to ESG and sustainability-related issues are rapidly developing internationally. Examples include the UK’s Modern Slavery Act 2015, s 54, as well as provisions recently introduced

⁶⁴ Section 263(2)(c) and section 263(3)(c) and (d) of the Companies Act 2006.

⁶⁵ A. Keay, ‘Assessing and rethinking the statutory scheme for derivative actions under the Companies Act 2006’ (2016) 16 (1) *Journal of Corporate Law Studies* 39 at 41.

⁶⁶ Martin, R., Casson, P. D., & Nisar, T. M. (2007) *Investor engagement: Investors and management practice under shareholder value*, (Oxford: Oxford University Press); McNulty, T., & Nordberg, D. (2016) ‘Ownership, activism and engagement: Institutional investors as active owners’, *Corporate Governance: An International Review*, 24(3), 346-358; Hopt, Klaus J., ‘The Dialogue between the Chairman of the Board and Investors: The Practice in the UK, the Netherlands and Germany and the Future of the German Corporate Governance Code Under the New Chairman’ (September 1, 2017) ECGI - Law Working Paper No. 365/2017, available at SSRN: <https://ssrn.com/abstract=3030693>

⁶⁷ Carleton, Willard T, James M Nelson, and Michael S Weisbach, (1998), ‘The influence of institutions on corporate governance through private negotiations: Evidence from TIAA-CREF,’ *The Journal of Finance*, 53(4) 1335-62.

⁶⁸ Hirschman, Albert O. (1970) *Exit, Voice, and Loyalty. Responses to Decline in Firms, Organizations, and States* (Cambridge/Mass.: Harvard University Press).

⁶⁹ Semenova, N. (2020) ‘Company Receptivity in Private Dialogue on Sustainability Risks’, *Sustainability* 12(2), 532.

⁷⁰ See McNulty and Nordberg, above noted, at 354.

as an amendment to the Companies Act 2006 requiring non-financial information and statement on section 172,⁷¹ in France the recent Vigilance law of 2017⁷², and in the Netherlands a Child Labour Provision was recently enacted.⁷³ At EU level the Non-Financial Reporting Directive of 2014⁷⁴ contains provisions for reporting on ESG matters and on 29 April 2020, the European Commissioner for Justice, Didier Reynders, announced that the Commission commits to introducing rules for mandatory corporate environmental and human rights due diligence.⁷⁵ These are promising developments towards getting companies to address sustainability, ESG and human rights issues. They provide a background for growing support for adopting a cross-sectoral legal mechanism via a due diligence law that would shift the emphasis away from box-ticking towards companies reporting on the outcomes of their actions and policies.⁷⁶ Institutional investors increasingly favour the introduction of mandatory due diligence requirements.⁷⁷ However, such reporting and due diligence provisions, whilst important steps, will not guarantee sustainability or full protection of human rights. Indeed, at present there is a case for cleaning up what has become a messy and often incoherent collection of non-financial reporting and due diligence laws in order to bring greater clarity and effectiveness to these activities.⁷⁸ Furthermore, following the Coronavirus Pandemic and the predicted

⁷¹ The Companies (Miscellaneous Reporting) Regulations 2018, SI 2018, No. 860, Regulation 4: ‘After section 414C insert— “Section 172(1) statement 414CZA –

(1) A strategic report for a financial year of a company must include a statement (a “section 172(1) statement”) which describes how the directors have had regard to the matters set out in section 172(1)(a) to (f) when performing their duty under section 172.

⁷² French Vigilance Law, LOI n° 2017-399 du 27 mars 2017 relative au devoir de vigilance des sociétés mères et des entreprises donneuses d'ordre (1), *JORF* n°0074 du 28 mars 2017, texte n° 1.

⁷³ Dutch child labour due diligence law, 14 May 2019, Wet van 24 oktober 2019 houdende de invoering van een zorgplicht ter voorkoming van de levering van goederen en diensten die met behulp van kinderarbeid tot stand zijn gekomen (Wet zorgplicht kinderarbeid), Staatsblad van het Koninkrijk der Nederlanden, Jaargang 2019 [Wet zorgplicht kinderarbeid]

⁷⁴ Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups.

⁷⁵ See announcement, EU Commissioner for Justice commits to legislation on mandatory due diligence for companies, Business and Human Rights Resource Centre, at <https://www.business-humanrights.org/en/eu-commissioner-for-justice-commits-to-legislation-on-mandatory-due-diligence-for-companies>

⁷⁶ Lise Smit, Claire Bright, Robert McCorquodale, Matthias Bauer, Hanna Deringer, Daniela Baeza-Breinbauer, Francisca Torres-Cortés, Frank Alleweldt, Senda Kara and Camille Salinier and Héctor Tejero Tobed, *Study on due diligence requirements through the supply chain, Final Report*, (January 2020, European Commission, Directorate General for Justice and Consumers)

⁷⁷ European Parliament Working Group on Responsible Business Conduct, *Investors Call On Mandatory Human Rights Due Diligence*, April 24, 2020, at <https://responsiblebusinessconduct.eu/wp/2020/04/24/investors-call-on-mandatory-human-rights-due-diligence/>

⁷⁸ See for a discussion, Tsagas G and Villiers C., ‘Why “less is more” in non-financial reporting initiatives: concrete steps towards supporting sustainability’, forthcoming in *Accounting, Economics and Law: A Convivium (CONVIVIUM)*. Note also the European Commission’s plans and consultation on reform of the Non-Financial Reporting Directive: European Commission, Public Consultation - Non-financial reporting by large companies (updated rules), 20 February 2020, at <https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12129-Revision-of-Non-Financial-Reporting-Directive/public-consultation>

negative economic impact, it is possible that for investors ESG interests could take a back seat and be deprioritised against a company's economic recovery.⁷⁹

2.5. Takeovers and mergers

Alongside these company laws and the corporate governance framework, the UK Takeover Code comprises a set of principles and rules designed to ensure fair treatment of all shareholders in an offeree company within an orderly takeover process, supervised by the Panel on Takeovers and Mergers. The Code operates to provide the shareholders an opportunity to decide the merits of a takeover.⁸⁰ It gives priority to the shareholders as decision-makers in a takeover scenario but it also contains a provision requiring shareholders to consider the impact of any takeover on the employees of the target company.⁸¹ There are no provisions relating directly to ESG issues or to sustainability. The potential for a positive relationship between takeovers and mergers and sustainability or ESG appears overall to be significantly limited. There is no mention of environmental impacts in the Takeover Code and the social impact of a takeover is covered by a very limited reference to the impact on employees, with the decision of their fate being effectively decided by the shareholders of the target company. The European Takeovers Directive, having been largely inspired by the UK's takeovers framework, is similarly limited, although in some European countries where codetermination is established, workers, through their board representatives will have some involvement in the decision-making process in a takeover situation.⁸² Despite this lag in the regulatory approach to takeovers and mergers and the ESG impact, evidence appears to be growing that investors see CSR performance and ESG issues as increasingly relevant factors in their deal-making decisions.⁸³

2.6 Summary

The UK company law and corporate governance framework is known worldwide for its flexible and pragmatic, and relatively non-interventionist, approach designed to serve the interests of businesses and their investors. This reputation builds on a system organised around an assumption that shareholders take priority in the governance of the company, and that the primary motivation of all shareholders is to seek profit. The performance measures on which directors are mostly judged, therefore, revolve around quarterly return on investment, although this is not what the law requires at all times. We have seen for example that an enlightened approach will permit company directors to take account of other stakeholder interests including ESG issues. The corporate governance framework, following recent revisions, indeed requires stakeholder engagement and stresses the importance of sustainability and long-term planning.

To a degree, this system of company law and corporate governance has been successful by operating efficiently within the current welfare paradigm insofar as shareholders and directors have enjoyed large wealth gains and it has contributed to economic growth. Success has not however come without widespread negative side effects where,

⁷⁹ Boston Consulting Group, Covid19, Investor Pulse Check #4 Survey, 1-3 May 2020, at https://image-src.bcg.com/Images/COVID_investor_pulse_4_final_tcm9-246326.pdf

⁸⁰ <http://www.thetakeoverpanel.org.uk/the-code/download-code>

⁸¹ General Provision 2, Takeover Code.

⁸² See further, Banakas, Théodore, 'The Benefits of Corporate Social Responsibility on Mergers and Acquisitions' (2018) at https://researcharchive.vuw.ac.nz/xmlui/bitstream/handle/10063/8434/paper_access.pdf?sequence=1.

⁸³ See eg Holmstedt-Pell, E. 'How ESG is changing the market for mergers and acquisitions', *Responsible Investor*, 2 September 2019, at <https://www.responsible-investor.com/articles/esg-mergersandacquisitions1> and see also Mathieu Gomes, 'Does CSR influence M&A target choices?' *Finance Research Letters*, Elsevier, 2019, 30, pp.153-159.

notwithstanding some regard for ESG issues, fundamentally this system has been allowed to operate from a short-term perspective meant to satisfy the demands for regular profit income and to enable companies to stay ahead of the competition for growth. The “toxic” side effects include worker exploitation and environmental harm,⁸⁴ and even at the level of economic prosperity, not everyone has benefited from the gains made. Continued social injustices and widening trends of socio-economic inequality have become a focus of attention in Britain, as they have around the world, with climate and human rights activists campaigning for change.⁸⁵

Like other systems around the world, the framework continues to face the pressure of global financial markets and activist hedge funds. That said, investors themselves are not a homogenous group and those that have longer term goals have supported shifts towards greater integration of ESG and sustainability issues into their investment decisions. However, other shareholders still hold onto short-term, financial performance-oriented goals. Some of the gains made in the developments towards prioritising ESG issues may not be sufficiently strong enough, either, to withstand the coming economic downturn in the aftermath of the Covid-19 pandemic.

From a sustainability perspective, given these continuing pressures, the system is legally and culturally problematic. It presents a barrier to achieving the adjustment to the welfare paradigm that we regard as necessary for the shift to sustainability. A number of large-scale research projects now recognise this and seek change, many with the support of corporate initiatives.⁸⁶ There is clear frustration even among doctrinal company lawyers about the systemic resistance to change.⁸⁷ Momentum, in other words, has grown to support real change towards sustainability in company law and corporate governance, and the COVID-19 pandemic appears to have further strengthened the resolve of this movement.⁸⁸

⁸⁴ Talbot, Lorraine, *Progressive corporate governance for the 21st century* (Routledge, 2013); see also Lynn A. Stout ‘The Toxic Side Effects of Shareholder Primacy’ (2013) *University of Pennsylvania Law Review*, Vol 161, 2003-2023.

⁸⁵ See eg Labour Party, *Rewriting the Rules: Labour’s Vision for Corporate Governance, Accountability, and Regulation*(2019) <https://labour.org.uk/wp-content/uploads/2019/11/rewriting-the-rules.pdf>, and see further New Economics Foundation, *Shareholder Capitalism: A System in Crisis*, 2017, online at https://neweconomics.org/uploads/files/NEF_SHAREHOLDER-CAPITALISM_E_latest.pdf, and Prem Sikka et al, *A Better Future for Corporate Governance: Democratising Corporations for their Long-Term Success*, September 2018, online at <http://visar.csustan.edu/aaba/LabourCorpGovReview2018.pdf>

⁸⁶ See e.g. <http://www.biginnovationcentre-purposeful-company.com/> and <https://www.thebritishacademy.ac.uk/programmes/future-of-the-corporation>

⁸⁷ Talbot, L. (2016) ‘Trying to save the world with company law? Some problems’ *Legal Studies*, 36(3), 513-534.

⁸⁸ ICGN Viewpoint Coronavirus as a new systemic risk: implications for corporate governance and investor stewardship, 12 March 2020, at <https://www.icgn.org/sites/default/files/ICGN%20Viewpoint%20Coronavirus-%20investor%20expectations%20of%20boards.pdf> and see for a more radical reform proposal following Covid-19: Scott, M. ‘From ‘E’ to ‘S’ and ‘G’ as responsible investors take stock post-pandemic’ *Ethical Corporation*, 2 May 2020 at <http://ethicalcorp.com/e-s-and-g-responsible-investors-take-stock-post-pandemic> ; see also Villiers, C, ‘The Coronavirus Crisis: Compassionate Leadership is Relevant Now More than Ever’ *University of Bristol Law School Blog*, 24 March 2020.

3. Options for system change towards sustainability

Legislative change can happen quickly in the field of company law and corporate governance when there is urgency to respond in a crisis. We saw this in the UK's responses to the 2008 global financial crisis leading to, amongst other things, the passing of the UK Stewardship Code in its aftermath. We have seen it again in 2020 with the quick passage of the UK Corporate Insolvency and Governance Act 2020 to introduce new measures to rescue companies in financial distress as a result of the economic crisis caused by the pandemic. Indeed, the evolution of the UK corporate governance framework can be described as piecemeal development in response to a consecution of corporate governance failures and crises over several decades, going back to the 1992 Cadbury Report itself that led to the first version of the UK Code.

On the other hand, reform efforts until now have been not only incremental but also, from the perspective of sustainability, mostly underwhelming, generally reconfirming the status quo. Many of the steps taken over time to strengthen the framework lacked clarity in their conviction and effectiveness. Often, these reforms sidestepped calls for more extensive legislative intervention and change. Indeed, in an important recent development, corporate leaders globally have themselves begun to make greater noise for sustainability, even advocating a move beyond the existing shareholder focus.⁸⁹ But on this, progress has been slow and we are yet to see this translated into tangible results in the form of, for example, an overhaul of some of the underpinnings of existing UK company law. It is unclear what political scope there is currently for further change of the UK framework, but it is possible that the scale of disruption caused by the pandemic and the urgency of current climate threats might finally open-up a political window for further-reaching reform. We argue that such a reform to provide the system change for corporate sustainability would require a departure in some areas of company law from the UK's traditionally non-interventionist and market-based system in favour of a more prescriptive and interventionist approach. It requires an outlook on sustainable companies that, while continuing to be based on pragmatism and flexibility and economic incentives, does also incorporate further company regulation.

3.1. Institutional change

The system is currently too reliant on industry expertise to be effective at implementing real change, and it tends to represent predominately corporate interests.⁹⁰ The role of non-binding codes and of institutions, like the FRC and the Panel for Takeovers and Mergers, that are not subject to full democratic scrutiny, are barriers to change for sustainability and an enhanced regulatory system is required that 'reasserts the public interest in the way companies are run and managed.'⁹¹ It remains to be seen how the transformation of the FRC into the new ARGA (see section 2.2.3 above) will tackle these issues. We can be fairly sure however, given early announcements, that it will not address our current concerns comprehensively. Further changes to the institutional framework will be necessary to address these. Would, for example, an apply and explain approach, replacing the comply or explain approach, strengthen and make the Corporate Governance Code any more effective? Can the application of the various codes be made more effective

⁸⁹ See e.g. Business Roundtable Statement on the Purpose of the Corporation, 2019 and updated in 2020, <https://opportunity.businessroundtable.org/wp-content/uploads/2020/09/BRT-Statement-on-the-Purpose-of-a-Corporation-September-2020.pdf>

⁹⁰ F.W. Mayer, 'Leveraging private governance for public purpose: Business, civil society and the state in labour regulation' in A. Payne, N. Phillips, *Handbook of the international political economy of governance* (2014) 344-360, at 357-58.

⁹¹ Simon Deakin, 'Reversing Financialisation' at <https://blogs.lse.ac.uk/netuf/2018/09/03/reversing-financialisation-shareholder-value-and-the-legal-reform-of-corporate-governance/>

by restructuring and unifying them, potentially incorporating rules for large private companies? These are important questions worthy of deeper consideration because they point towards some fundamental issues of regulatory structure and conceptual approach. Indeed, regulatory structures remain relevant and the issues they focus upon can be changed. This is a matter of choice which could include ESG issues, just as some other regulators recognise. This may involve a simple review of regulatory matters for the FRC, and its successor, the ARGA, but it is likely also to require more substantial reform of the institutional character, scope and powers of the regulatory structure e.g. aligning them with those in the utilities sectors.

3.2. Directors' duties

Central in a shift towards sustainability will no doubt be a review of the provisions on company directors' duties and their practical application, and in particular, the fate of section 172 of the Companies Act 2006 (see above section 2.1). This includes the provision's substantive scope but for its full potential to be realised, the surrounding enforcement infrastructure of section 172 also needs reform. The provision currently enables directors to have regard to stakeholders and, by extension, to sustainability. But only an investor or the company can take action against a director for an alleged breach.

A non-interventionist evolution involves encouraging individual companies and their investors to allow company directors to make greater use of the flexibility provided within the existing provision. A growing number of companies have in fact identified this flexibility as an important tool in giving their business a mission beyond profit, and there are now specific legal blueprints to adjust the company articles to that effect.⁹² The B Corp certification process, a voluntary procedure whereby companies registered in the UK can get themselves certified as stakeholder-oriented firms, provides such a blueprint. To be registered as a B Corp, a company must, among other things, adopt an alternative wording in its constitution based on the wording of section 172 but more ambitious in committing the company to a purpose wider than profit, and the company directors to take account of stakeholder interests.⁹³

This approach, based on a combination of individual choice and social commitment, aligns with the British company law tradition of providing a flexible and incentive-based framework. However, disadvantages of this voluntary system include the inevitable fact that these commitments always remain reversible. Pressure from shareholders, an economic shift, or a change in company membership may then lead to a reversion back to

⁹² See e.g. Advisory panel to the UK government's Mission-Led Business Review 2016, Report 'On a Mission in the UK Economy', available https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/574694/Advisory_Panel_Report_-_Mission-led_Business.pdf

⁹³ See <https://bcorporation.uk/>; for discussion see D Hunter, 'The arrival of B Corps in Britain: another milestone towards a holistic economy?', in N Boeger and C Villiers (eds.) *Shaping the Corporate Landscape* (Hart Publishing, 2018). The adjusted wording reads:

1) The purposes of the Company are to promote the success of the Company for the benefit of its members as a whole and, through its business and operations, to have a material positive impact on society and the environment, taken as a whole.

2) A Director shall have regard (amongst other matters) to:

a) the likely consequences of any decision in the long term,
b) the interests of the Company's employees,
c) the need to foster the Company's business relationships with suppliers, customers and others,
d) the impact of the Company's operations on the community and the environment,
e) the desirability of the Company maintaining a reputation for high standards of business conduct, and
f) the need to act fairly as between members of the Company,
(together, the matters referred to above shall be defined for the purposes of this Article as the "Stakeholder Interests").

profit-maximisation unless more coercive formats are found. There is also concern that mission-driven formats may be conducive to ‘mission-wash’⁹⁴ in a way similar to the well-known phenomenon of green-washing and white-washing in CSR.⁹⁵ A further issue relates to a continuing need for reform of enforcement to enable stakeholders, to whom these companies make their commitment, to take action against directors to enforce them. Currently, even in these adjusted formats, only shareholders can do so, and enforcement has in practice been ineffective.⁹⁶ At this stage it is hard to see how these alternative business formats can channel system reform on a larger and long-term scale without further-reaching changes that also involve legislative review.

Among other things, the derivative action procedure would form part of a thorough review process, with a view to simplifying it further to increase speed and reduce costs so that shareholders will be more inclined to take action against directors. An enhanced regulatory system would also include more wide-ranging enforcement measures as well as take steps to ensure that shareholders take their responsibilities more seriously. For example, the UN Principles of Responsible Investment (PRI) recently adopted the threat of delisting for signatories who do not implement its principles.⁹⁷ Could this example be acted on in other areas of company law and corporate governance?

There is scope for section 172 to be reformed, especially in combination with an enhanced regulatory system. A simple change would include more direct reference to future generations of stakeholders which is currently absent. But this alone is unlikely to bring about a cultural shift. Elsewhere, more comprehensive proposals have been developed to subject directors to a ‘legally-binding obligation to develop, disclose and implement, on behalf of the company a forward-looking corporate sustainability strategy.’⁹⁸ To operationalise this obligation and ensure that the strategy covers relevant matters, it is proposed for the law to ‘specify a limited set of sector-specific issues and public objectives’⁹⁹ that may be addressed on a ‘comply or explain’ or ‘apply and explain’ basis. The directors’ accountability for discharging these duties, and for implementing the corporate sustainability strategy, would be secured by a requirement to include within the strategy ‘verifiable targets’ backed by a commitment of resources, which are also linked to directors’ remuneration. Failure to implement would be considered a breach of duty and subject to enforcement by derivative action.¹⁰⁰ This may also need to involve some form of enforcement power for stakeholders other than company shareholders - for

⁹⁴ See Boeger, N., & Hunter, D. (2018) ‘Mission-led Business: CSR reboot or paradigm shift?’ (pp. 1-26). (Bristol Law Research Paper Series; Vol. 2018, No. 001). Bristol: School of Law, University of Bristol.

⁹⁵ Cherry, M. A. (2013) ‘The law and economics of corporate social responsibility and greenwashing’ *UC Davis Bus. LJ*, 14, 281.

⁹⁶ For similar concerns relating to the Benefit Corporation format in the US, see e.g. Briana Cummings, ‘Benefit Corporations: how to enforce a mandate to promote the public interest’, *Columbia Law Review* Vol. 112, No. 3 (2012), pp. 578-627; Jaime Lee, ‘Benefit Corporations: A Proposal for Assessing Liability in Benefit Enforcement Proceedings’, 103 *Cornell L. Rev.* 1075 (2018)

⁹⁷ See UN PRI *A Blueprint for Responsible Investment* (2017-2027) at <https://www.unpri.org/download?ac=5330>

⁹⁸ A Johnston et al., *Corporate Governance for Sustainability*, 2020, <https://corpgov.law.harvard.edu/2020/01/07/corporate-governance-for-sustainability-statement/>

⁹⁹ *Ibid.*

¹⁰⁰ *Ibid.*

example, through a national regulatory body empowered to bring proceedings¹⁰¹ - to make accountability more effective.

Any changes along these lines would also have implications on the UK corporate governance framework as the current section 172 statement would need to be altered, with the potential also to impact on companies' transparency in disclosure and reporting obligations (see below). While the operation of this new procedure may render the application of directors' duties and their enforcement more complex initially, these challenges would likely ease off with growing expertise over time, and it could, if properly implemented, save transaction costs in the application of external regulation for sustainability by way of social and environmental laws.

3.3. Shareholder Stewardship

Should shareholders have a leading role in achieving corporate sustainability? This question divides opinion.¹⁰² One view concedes that, despite the existing flexibility in the law (see above section 2.1), the UK is unlikely to see a move from shareholder primacy in the short or medium term. That being the case, we seek to harness their influence in pursuit of sustainability and acknowledge that for a sustainable system it is best to (continue to treat) shareholders as central and rely on their potential and power to transform and encourage this (see also section 1 above). In the UK, the Stewardship Code already requires institutional shareholders to act as responsible owners, albeit in a non-binding manner and its effectiveness has been debateable (see above 2.2.2). Moreover, measures to support more shareholder engagement for sustainability are growing also in other systems and internationally,¹⁰³ including initiatives driven by activist investors,¹⁰⁴ now reflected in the EU sustainable investment strategy and European Green Deal initiative.¹⁰⁵

Reliance on powerful shareholders is not, however, without risk. By encouraging greater activism by investors, the position of shareholders as the key focus for corporate leaders is further entrenched or enhanced. It also risks the goal of sustainability being modified to fit with more fundamental investor concerns of maximal dividend returns and capital gains, and on some matters they simply disengage or exercise their votes only in a very

¹⁰¹ Ibid.

¹⁰² For an interesting overview of the different opinions see Hill, Jennifer G. 'Good activist/bad activist: The rise of international stewardship codes' *Seattle UL Rev.* 41 (2017) 497.

¹⁰³ See, for example, the EU's Second Shareholder Rights Directive (Directive 2017/828/EU amending Directive 2007/36/EC) as cited above in section 2.2.2; see also Financial Services Commission of Ontario, Investment Guidance Note, IGN-004, Environmental, Social and Governance (ESG) Factors, effective from 1 January 2016, at <https://www.fsco.gov.on.ca/en/pensions/policies/active/Documents/IGN-004.pdf>; in the US, an investor-led stewardship initiative was launched in January 2017, by the Investor Stewardship Group, the Framework for US Stewardship and Governance, including *The Principles, Stewardship Framework for Institutional Investors*, at <https://isgframework.org/stewardship-principles/>

¹⁰⁴ There is evidence of growing membership of the UN PRI: membership has grown to more than 3000 signatories at 18 May 2020: <https://www.unpri.org/pri> See also Letter of Larry Fink, Blackrock, 1 February 2016, to S&P 500 CEOs, urging a long term perspective. See further Robert G. Eccles and Svetlana Klimenko, 'The Investor Revolution,' *Harvard Business Review*, May-June 2019 at <https://hbr.org/2019/05/the-investor-revolution>

¹⁰⁵ See Communication from the EU Commission on the Sustainable Europe Investment Plan, COM(2020) 21 final, 14 January 2020 at <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52020DC0021>; and Communication from the EU Commission on the European Green Deal, COM(2019) 640 final, 11 December 2019 at <https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1576150542719&uri=COM%3A2019%3A640%3AFIN> .

fragmented way.¹⁰⁶ As we are seeing evidence that investors take interest in ESG issues, frequently this appears linked to possibilities of continued wealth or as a strategy to avoid risk.¹⁰⁷ Research conducted for McKinsey & Co in 2017 noted that the top three motivations for pursuing sustainable investing among institutional investors were to enhance returns; strengthen risk management and align strategies with the priorities of beneficiaries and stakeholders.¹⁰⁸ Different researchers suggest that ESG diligence among fund managers is mainly driven by a desire to mitigate risk and exhibits herding behaviour whilst these researchers claim that additional value creation is not a strong motivation.¹⁰⁹ Consumer explanations for investment in SRI profiled mutual funds show a mixture of motives between profit considerations and more altruistic social concerns.¹¹⁰ Prudent risk management is a factor for the private equity community but so is finding a source of new value creation and differentiating an investor from its competitors.¹¹¹ Given the fact that shareholders are not represented by one homogenous group, there may be many social and psychological differences among their reasons for sustainable investment.¹¹² More comprehensive research therefore is needed on the question of what drives those shareholders who do pursue a sustainability agenda, and how effective the existing socially responsible investment (SRI) movement has been.¹¹³

As a starting point, we observe leaders and followers among two different categories of shareholder: those that stall or delay the transition towards sustainability ('brakers') and those that drive towards sustainability ('pushers'). The brakers are led by hedge funds and followed often by individual retail investors whose main priority is to receive dividends from profits and increased share value. The pushers are led by investor groups such as those in the UN PRI and SRI investors as well as campaign shareholders such as those in Share Action and they are followed by institutional investors who are increasingly seeing

¹⁰⁶ Ashley Walsh, 'The myth of shareholder stewardship: How Effectively Do Shareholders oversee FTSE 100 CEO Pay?' High Pay Centre, May 2019, at http://highpaycentre.org/files/myth_of_shareholder_stewardship.pdf

¹⁰⁷ See for example, Morgan Stanley's *Investing with Impact Platform* which highlights to its clients the business case for ESG investing at <https://www.morganstanley.com/articles/investing-with-impact>; Larry Fink highlights in his recent letter to clients that 'investors are increasingly ... recognizing that climate risk is investment risk.' See Larry Fink's letter to CEOs, A Fundamental Reshaping of Finance, 15 January 2020 at <https://www.blackrock.com/uk/individual/larry-fink-ceo-letter>?siteEntryPassthrough=true&cid=ppc:CEOLetter:Google:responsive:UK:keyword&gclid=EAlaIqobChMlp-DnjJa95wIVmK3tCh2dugdNAAAYASAAEgJbSvD_BwE .

¹⁰⁸ See Sara Bernow, Bryce Klemperer, and Clarisse Magnin, 'From 'why' to 'why not': Sustainable investing as the new normal', October 25, 2017, McKinsey & Co, at <https://www.mckinsey.com/industries/private-equity-and-principal-investors/our-insights/from-why-to-why-not-sustainable-investing-as-the-new-normal>

¹⁰⁹ Przychodzen, J., Gómez-Bezares, F., Przychodzen, W., & Larreina, M. (2016) 'ESG Issues among fund managers—Factors and motives' *Sustainability*, 8(10), 1078.

¹¹⁰ J. Nilsson, 'Investment with a Conscience: Examining the Impact of Pro-Social Attitudes and Perceived Financial Performance on Socially Responsible Business Behavior' (2008) 83 *Journal of Business Ethics* 307 at 320-321.

¹¹¹ P. Crifo and VD Forget, 'Think global, invest responsible: Why the private equity industry goes green' (2013) 116 (1) *Journal of Business Ethics* 21.

¹¹² Signori, S. (2020) 'Socially Responsible Investors: Exploring Motivations and Ethical Intensity' *Handbook on Ethics in Finance*, 1-23.

¹¹³ P. Rivoli, 'Making a Difference or Making a Statement? Finance Research and Socially Responsible Investment' (2003) 13 (3) *Business Ethics Quarterly* 271.

that this is the trajectory and so they will support it, often encouraged to do so by their clients. The following table illustrates this.

Table 1: Shareholder characteristics according to commitment to sustainability

	Brakers	Pushers
Leaders	Hedge Funds	Share Action/UNPRI/SRI
Followers	Individual retail investors	Institutional Investors e.g. divesting funds, bandwagon, client driven

How effective have the ‘pushers’ been to date? UN PRI is a voluntary organisation with approximately 3000, signatories around the world (2220 investment managers, 530 asset owners and 330 service providers).¹¹⁴ SRI is a growing industry - to what extent has it persuaded companies and other shareholders to change their investment goals and activities? Are they making a positive impact? Whilst there is some evidence to suggest that shareholder investing and engagement in sustainability may have a positive impact on corporate conduct and sustainability performance,¹¹⁵ a growing literature suggests that it is still difficult to identify and quantify the effects of SRI investment, and that overall, SRI does not yet play a major role in changing ESG performance.¹¹⁶ Clearly their efforts to date are not enough because we are still witnessing continuing rise of carbon emissions and societal injustices in which corporations play a part.

If the system choses a stewardship model that involves and continues to prioritise shareholders, then how can it mobilise them in the pursuit of sustainability? This will, for one, require more transparency in company reports and disclosure to show that information is comprehensive and suited (see further below). But this alone is unlikely to be enough. A reformed legal regime would be required to enhance stewardship substantially, following existing proposals to impose on investors, at every level of the investment chain, legally binding obligations to consider, identify and disclose ESG risks and issues.¹¹⁷ It would also mean encouraging or imposing voting and shareholding structures that ensure shareholder voice (see above section 2.3) will take account of long-term interests and that good stewardship is both rewarded and reinforced. This would involve forms of trust or foundation ownership or a restructuring of voting rights.¹¹⁸

¹¹⁴ See note 92 above.

¹¹⁵ Barton, B. (2018) *The Role Of Investors In Supporting Better Corporate ESG Performance: Influence strategies for sustainable and long-term value creation*, (Ceres) at <https://docs.merid.org/SITECOREDOCS/The%20Role%20of%20Investors%20in%20Supporting%20Better%20Corporate%20ESG%20Performance.pdf>; citing also Ceres (2015) *Shareholders Spur Action on Climate Change: Company Commitments from the 2014 and 2015 Proxy Seasons*, at https://www.ceres.org/sites/default/files/reports/2017-03/Ceres_CoCommitTracker_100615.pdf ; and Grewal, Serafeim and Yoon (2016) ‘Shareholder Activism on Sustainability Issues’ Harvard Business School Working Paper, No 17-003, at <https://dash.harvard.edu/bitstream/handle/1/27864360/17-003.pdf?sequence=1>

¹¹⁶ See eg Frank A.J. Wagemans, C.S.A. (Kris) van Koppen & Arthur P.J. Mol (2013) ‘The effectiveness of socially responsible investment: a review’ *Journal of Integrative Environmental Sciences*, 10:3-4, 235-252.

¹¹⁷ A Johnston et al., *Corporate Governance for Sustainability*, 2020, <https://corpgov.law.harvard.edu/2020/01/07/corporate-governance-for-sustainability-statement/>

¹¹⁸ See eg Purpose Foundation, *Steward Ownership: rethinking ownership in the 21st century*, 2019, https://purpose-economy.org/content/uploads/purposebooklet_en.pdf

At the EU level, the Green Deal and the sustainable finance initiative provide some reason for optimism. The goal is to “support the delivery on the objectives of the European Green Deal by channelling private investment into the transition to a climate-neutral, climate-resilient, resource-efficient and just economy, as a complement to public money.”¹¹⁹ Connected to this Green Deal objective is the sustainable finance initiative which is designed to encourage (a) finance to support economic growth while reducing pressures on the environment and taking into account social and governance aspects, (b) transparency on risks related to ESG factors that may impact the financial system, and (c) mitigation of such risks through the appropriate governance of financial and corporate actors.¹²⁰

In 2020 the Commission announced a renewed sustainable finance strategy, with the aim of providing “the policy tools to ensure that financial system genuinely supports the transition of businesses towards sustainability in a context of recovery from the impact of the COVID-19 outbreak.” The intention is that the renewed strategy “will contribute to the objectives of the European green deal investment plan, in particular to creating an enabling framework for private investors and the public sector to facilitate sustainable investments.”¹²¹ The renewed strategy will focus on three areas: strengthening the foundations for sustainable investment by creating an enabling framework, with appropriate tools and structures; increased opportunities to have a positive impact on sustainability for citizens, financial institutions and corporates; and climate and environmental risks to be fully managed and integrated into financial institutions and the financial system as a whole, while ensuring social risks are duly taken into account where relevant.¹²² Part of the efforts towards achieving sustainable finance, resulted in the creation of a Taxonomy Regulation on the establishment of a framework to facilitate sustainable investment, which includes an EU classification system for sustainable activities.¹²³

As the UK’s Brexit transition period ends for leaving the EU on 31st December 2020, there is some ambiguity about the extent to which the UK will continue to retain this aspect of EU law. Whilst the Taxonomy Regulation was enacted on 2020 and so would appear to meet the criteria for being retained, because it was enacted during the transition period, the delegated, technical legislation that will give practical effect has not all been developed. Therefore, although the Regulation entered into force on 12 July 2020, it cannot start applying in practice until the technical screening criteria have been adopted. The first of these will not come into force until 1 January 2022 and the remaining four will not come into force until 1 January 2023. Similar problems exist in connection with the EU

¹¹⁹ European Commission, Overview of Sustainable Finance, at https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/overview-sustainable-finance_en

¹²⁰ Ibid.

¹²¹ Ibid and see European Commission, *Consultation on the renewed sustainable finance strategy*, April 2020, at https://ec.europa.eu/info/sites/info/files/business_economy_euro_banking_and_finance/documents/2020-sustainable-finance-strategy-consultation-document_en.pdf.

¹²² Consultation, *ibid*, at 4.

¹²³ Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088, PE/20/2020/INIT, *OJ L 198*, 22.6.2020, p. 13-43, see also Technical Expert Group on Sustainable Finance, *Taxonomy: Final report of the Technical Expert Group on Sustainable Finance*, March 2020, available at https://ec.europa.eu/info/sites/info/files/business_economy_euro_banking_and_finance/documents/200309-sustainable-finance-teg-final-report-taxonomy_en.pdf

Sustainable Finance Disclosure Regulation.¹²⁴ Consequently, there is a question mark over the extent to which the UK government will require compliance with that EU legislation and instead create its own rules on sustainable finance, leading to extra complexity for investors, asset managers and other financial sector actors, and potentially for the UK financial sector to fall behind on the progress that has been made at EU level.¹²⁵ The UK government has not yet clarified its plans in this regard. It may be the case that institutional investors will, themselves, push action towards alignment with the EU strategy.¹²⁶

3.4. Governance

Going beyond stewardship, we expect other aspects of a reformed corporate governance system to challenge the central position of shareholders in current corporate culture to achieve real sustainability. If we accept that preferring investor interests over those of others is largely the result of political and economic choices rather than legal compulsion, this clears the way for directors to prioritise other concerns or certainly to generate profit in ways that are sustainable in the long-term. It reinforces the case for strengthening directors' duties to take account of ESG issues (see above), but also for giving stakeholders further governance rights as part of the general Code in a more fully interventionist system that would support the interests of the different constituents much more strongly. For example, it would include a requirement for employees to be fully included in the decision-making processes, more strongly than is currently being offered within the Corporate Governance Code. A codetermination system that raises the status of employees towards that of the shareholders would be required as a starting point towards de-commodifying work and ending the treatment of workers as no more than resources to be used for profitability.¹²⁷

More equitable pay ratios would also be introduced to replace the current system in which directors are widely recognised as being rewarded excessively and with incentives that are linked to short-term performance at the expense of more long-term, sustainable goals. The UK ranks at number 35 out of 40 OECD countries for income equality with a Gini coefficient of 0.357.¹²⁸ Greater parity of pay levels in the largest corporations may only be achieved through more extensive structural reforms such as strengthening trade union representation and facilitating collective bargaining more strongly, as well as ending the link between share value and pay and redirecting it towards connecting rewards with long-term and ESG performance.¹²⁹

¹²⁴ Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector PE/87/2019/REV/1, OJ L 317, 9.12.2019, p. 1-16.

¹²⁵ See Linklaters, *EU Taxonomy Regulation: will the UK government implement it in full after the Brexit transition period?* 21 September 2020, at <https://www.linklaters.com/en/insights/blogs/linkingessg/2020/september/eu-taxonomy-regulation-will-uk-government-implement-it-in-full-after-the-brexit-transition-period>

¹²⁶ Kentaro Kawamori, *EU Will Drive Climate Disclosure Regulation Much Like GDPR*, Bloomberg, 19 October 2020, at <https://news.bloomberglaw.com/environment-and-energy/eu-will-drive-climate-disclosure-regulation-much-like-gdpr>

¹²⁷ See #Democratizing Work, *Work: Democratize, Decommify, Remediate*, May 2020, at <https://democratizingwork.org>

¹²⁸ See OECD (2020), *Income inequality (indicator)*. doi: 10.1787/459aa7f1-en (Accessed on 18 May 2020)

¹²⁹ Executive pay is discussed extensively at the High Pay Centre website: <http://highpaycentre.org> See also Villiers, C. *Executive Pay: A socially oriented distributive justice framework*, (2016) *The Company Lawyer* 37:5 139.

More extensive protection of the environment will also be needed and should be integrated more strongly into the corporate governance structure. This can be achieved by one or a combination of initiatives such as exposing managers to personal risk liability for breach of legal and regulatory requirements aimed at environmental protection,¹³⁰ appointment of boardroom members with special mandate for focusing on environmental matters, closer linkage between directors' rewards and environmental performance, introducing jurisdiction for environmental groups and other stakeholders to be able to challenge directors for breach of their duty to promote the success of the company. New sanctions could be introduced that include the possibility of quoted companies being delisted from the London Stock Exchange for repeated environmental damage or failure to curb emissions.¹³¹

3.5.Membership

In many existing companies the distinction between shareholders and stakeholders is bridged by the fact that company stakeholders - mostly employees - also hold company stock. Whether or not such shares have voting rights attached is for the discretion of the company. In some circumstances, employees may be granted 'employee shareholder' status in which they may be given at least £2,000 fully paid up shares with capital gains tax exemption up to £50,000, but it is not clear if these shares come with voting rights, and moreover, the status involves the employee shareholder giving up some important employment rights, including the right not to be unfairly dismissed.¹³² These arrangements are inadequate. We argue for a more equalised membership arrangement. In our view, the principles of shared or inclusive membership should align with the paradigm of sustainability and should give to those who contribute to the company both a voice and a share in its proceeds. Under a reformed system, how would these models be encouraged or even enforced? In 2018, proposals by the Labour shadow chancellor to enforce 10 per cent share of employee shareholdings in large firms in the British economy reignited the row between advocates and critics of employee ownership.¹³³ We know that the 2018 initiatives were unsuccessful but in light of the impact of the COVID-19 pandemic on employees and on shareholders, it seems apt to reconsider this.¹³⁴

Following COVID-19 related bailouts and the taking by other European governments of a public stake in large companies that have received state support,¹³⁵ we should also consider the scope to develop the role of sovereign wealth under a sustainable company law system. One possibility is for the Government to insist that those companies that have been assisted through bailouts or the job retention scheme will in future adopt fairer pay practices and engage in responsible business conduct with regard to issues such as tax or climate change.¹³⁶

¹³⁰ See eg Kock, C. J., Santaló, J., & Diestre, L. (2012) 'Corporate governance and the environment: what type of governance creates greener companies?' *Journal of Management Studies*, 49(3), 492-514.

¹³¹ This suggestion was made in Labour Party, *Rewriting the Rules: Labour's Vision for Corporate Governance, Accountability, and Regulation*, Policy Paper, (2019) at 9-10, at <https://labour.org.uk/wp-content/uploads/2019/11/rewriting-the-rules.pdf>

¹³² See section 31 of the Growth and Infrastructure Act 2013.

¹³³ <https://boardagenda.com/2018/09/28/employee-ownership-a-help-or-hindrance-to-uk-business/>

¹³⁴ See note 106 above.

¹³⁵ <https://www.dw.com/en/german-govt-to-gain-251-stake-in-lufthansa-bailout-report/a-53304930>

¹³⁶ See High Pay Centre Briefing, *Corporate Response to the Economic Shutdown*, 26 April 2020, at <http://highpaycentre.org/pubs/high-pay-centre-briefing-corporate-response-to-the-economic-shutdown>

3.6. Transparency

Disclosure laws require further reform to improve the quality and comparability of non-financial information which is provided both to shareholders and to stakeholders. There is need for greater standardisation of standards and effective monitoring, including minimum sector-specific requirements.¹³⁷ Could we move beyond disclosure to demand systemic transparency and accountability, involving more proactive engagement with stakeholders in the production of the relevant information so as to generate genuine accountability?¹³⁸ One important change that could be made is that being campaigned for by Social Value UK, a network organisation seeking a change to section 396 of the Companies Act 2006, so that the true and fair view is defined within the Act to include information on the social and environmental impact of the enterprise.¹³⁹ Such a change would be consistent with the requirement for directors to show how they have complied with their duty under section 172.¹⁴⁰ There would be changes required for the role of auditors in this respect. They would audit the accounts against additional standards such as the Assurance Standard published by Social Value UK in 2017¹⁴¹ that sets out how companies seeking social value accreditation must demonstrate that their social reports comply with the seven principles of social value for measurement purposes identified also by Social Value UK.¹⁴² Standardising these approaches into the mainstream accounting and auditing processes would assist companies to produce more relevant and genuine company reports around sustainability issues. Sanctions for greenwash and whitewash would also need to be more stringent.

3.7. Takeovers

What are the opportunities for change? In Section 2.5 above we noted that investors increasingly take note of CSR and ESG performance in their deal-making considerations. It is also important to note that section 172 of the Companies Act 2006 is applicable in a takeover scenario and directors must be mindful of that duty in their own actions during the process of an acquisition. This could open a door to a more sustainability-oriented process. Perhaps it could also provide the basis for an argument for a more explicit principle to be introduced into the Code along these lines, perhaps by expanding General Principle 2 to include a requirement for the board of the offeree company, when advising the holders of securities, to give its views not just on the effects of implementation of the

¹³⁷ This is acknowledged by the European Commission: See The European Commission (EC) has launched an initiative 'Revision of the Non-Financial Reporting Directive', Press release 4 February 2020, <https://www.iasplus.com/en/news/2020/02/nfrd> and European Commission, Public Consultation -

Non-financial reporting by large companies (updated rules) 20 February 2020 at <https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12129-Revision-of-Non-Financial-Reporting-Directive/public-consultation> See also Tsagas and Villiers, above note 63, and A Johnston et al., Corporate Governance for Sustainability, 2020, <https://corpgov.law.harvard.edu/2020/01/07/corporate-governance-for-sustainability-statement/>

¹³⁸ See e.g. Stuart Cooper, 2018, 'Can Reduced Stakeholder Power Enable Corporate Stakeholder Accountability? The Case of Triodos Bank'. in: Nina Boeger, Charlotte Villiers (eds) *Shaping the Corporate Landscape: Towards Corporate Reform and Enterprise Diversity* (Hart Publishing, Oxford), pp. 233-251

¹³⁹ Social Value UK, 'How Do Companies Act? - Accounting To Save The Planet And People', at <http://www.socialvalueuk.org/how-do-companies-act-accounting-to-save-the-planet-and-people/>

¹⁴⁰ Ibid.

¹⁴¹ See Social Value International, *Assurance Standard*, December 2017, at <http://www.socialvalueuk.org/app/uploads/2017/08/Assurance-Standard-Dec-2017.pdf>

¹⁴² 'The Seven Principles of Social Value, Social Value UK', at http://www.socialvalueuk.org/app/uploads/2016/03/Principles%20of%20Social%20Value_Pages.pdf

bid on employment, conditions of employment and the locations of the company's places of business, but also on other ESG matters, including the environment. A wider set of reforms would also be introduced to give rise to more democratic accountability, enforcement and regulatory oversight into takeovers. These proposals might seem radical, but they also become increasingly necessary as the COVID-19 has exposed the dangers of larger corporations taking in smaller ones leading to market centralisation in times of crisis. At the same time the pandemic has forced potential strategic buyers to redirect the focus and energy of their teams away from acquisition growth towards instead taking care of the immediate health and survival of their own companies.¹⁴³ The pandemic has revealed a need for companies to think more about their resilience capabilities. This will drive us more than to consider moving towards a more holistic strategy for assessing takeovers.

3.8. Local economies

Local economies are increasingly recognised as important for achieving sustainability. The pandemic has arguably strengthened this point, given that global supply chains displayed little resilience to the impact of the pandemic as lockdowns began to bite into economies across the world. The Future Economy Network organisation's mission is to give organisations the space, knowledge and tools to become more sustainable and its website provides positive examples of learning and activity opportunities aimed especially at smaller businesses.¹⁴⁴ In Bristol, for example, the network has recently opened a carbon neutral business sustainability hub for the South West which provides space for events, co-working, retail and café.¹⁴⁵ The network organises meetings, webinars, seminars and networking opportunities for local entrepreneurs and individuals with expertise or interest in building sustainable economic activities. A key feature is the educational potential of these local networks that can help to grow sustainability across the broader economy. These activities would include campaigns for reform of company law to take account of new business needs that are compatible with sustainability. One example would include the campaign by Social Value UK which is currently working on a project, as noted above (section 3.6), to reform section 396 of the Companies Act 2006 to alter the meaning of the true and fair view principle, and such a reform would also entail further changes to section 172 and 178 of the Act to provide stakeholders with greater opportunity to hold directors to account.

¹⁴³ Richard Harroch, 'The Impact Of The Coronavirus Crisis On Mergers And Acquisitions', *Forbes*, 17 April 2020, at <https://www.forbes.com/sites/allbusiness/2020/04/17/impact-of-coronavirus-crisis-on-mergers-and-acquisitions/#1850cecb200a>

¹⁴⁴ The Future Economy Network at <https://www.thefutureeconomynetwork.co.uk>

¹⁴⁵ Future Leap, see at <https://www.thefutureeconomynetwork.co.uk>

Conclusion

Shareholders are a key stakeholder group in company law and corporate governance and their role in steps towards more sustainable business is essential. The facilitative character of the existing UK company law and corporate governance framework has allowed the dominance of arguments that the interests of shareholders are the primary goal of directors in exercising their duties and this has encouraged a short-term view of corporate goals to prevail, at the expense of other stakeholders and the social, environmental and economic interests of future generations. Yet, given their prevalence, shareholders have the potential to act as effective stewards of a company's assets for the long term, as well as the short term. Some shareholders are more willing to accept the challenge of this role, but others still hold onto a narrow pursuit of profit maximisation. This is possibly encouraged by the existence of a soft and minimalist regulatory framework that does little to incentivise long term thinking and instead enables rent-seeking behaviours by shareholders and by company directors. This report has presented possibilities for reshaping the framework with a number of system changes. It is essential that action is taken urgently. The coronavirus pandemic has highlighted some of the dangers of a non-resilient system and the looming threat of climate change demands that some of the proposed steps must be taken imminently.