

# Rethinking profit-driven investments structures

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our capital market  
framework for the  
collective good by*  
**Nicholas Benes**

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# "How we saved our planet"

*If rethinking profit-driven investment structures could defuse the ticking timebomb that threatens to destroy life as we know it, why isn't overhauling the capital market framework a global priority? Here, Nicholas Benes imagines the advice benign observers of our current doomed trajectory might give...*

Nicholas Benes, Representative Director of The Board Director Training Institute of Japan

In 2035, Earth received a visit from the planet Vilcan, its counterpart in a semi-parallel universe. The Vilcans were roughly 1,000 years ahead of Earth technologically and had been listening to Earth's radio and TV chatter for many years via the wormholes through which they subsequently made their way to our planet.

"We have come to give you advice; you seem to need it," the Vilcans said. "Just as almost occurred on our own planet about 1,200 years ago, you seem unable to fend off impending climate and environmental disasters of your own making. We would like to share with you how we overcame similar challenges, because you have no time to spare. It would make us sad to see civilisation die on a rare counterpart planet like Earth."

"Please tell us how you managed to do that?" asked Earth's delegation.

"We are a logical people, but a bit less individually self-centred than you seem to be. So, as Vilcan neared the 'irreversible' level of greenhouse gases, we purposely redesigned our capital market framework so that it incentivised much more desirable outcomes, and disincentivised negative externalities."

The Vilcans' advice as to how they did this was truly eye-opening.

## The basic principles

### ABOLISHING ANONYMOUS OWNERSHIP

"The first thing we did was to abolish absolute anonymity for shareholders. For all investors, encrypted ID numbers were issued. We used a distributed-network system similar to your 'blockchain' so that each and every share carried with it - and constantly updated - its own permanent record of exactly who had held it, for how long, and on whose behalf. Only by doing this, could we hope to track all investors' holdings so as to hold them accountable later for their engagement with companies and proxy voting, or for their toleration of inadequate sustainability policies by executives."

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### THE NINE STEPS VILCAN TOOK TO SAVE ITS PLANET

The Vilcans' advice to Earth had set forth at the end of its introduction: "From our point of view, most compensation or fee structures in your investment chain provide the wrong incentives." It then continued in more detail:

#### Structural incentives to benefit both company and society

Because we had concluded that full limited liability should not be enjoyed (or abused) 'for free', and, in fact, it distorted incentives, we modified the laws regarding 'corporations' or other types of pooled equity investment vehicles (such as mutual funds, ETFs, pension and endowment trusts, LLCs and LPs) as follows..."

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### HOW DID THE SYSTEM AVERT DISASTER? WHAT ABOUT EARTH?

Having described their redesigned equity capital market system, the Vilcans explained why it succeeded:

"As a result of these changes, for the first time in our history, all parts of the investment chain - asset owners and fund managers, executives and employees - were truly incentivised to consider how to maximise the long-term and profitable sustainability of companies, by diligently preparing in advance to cope with upcoming new regulations and changes in customer/societal expectations."

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"How We Saved our Planet" - Fundamen...



**"Like you, we had not rationally updated our obsolete stock ownership system for more than a century. Non-transparent practices detracted from the collective good. They attenuated responsibility and accountability."**



"You abolished custody accounts that cannot be easily traced to the end investor? It must have been incredibly hard to change a bedrock practice like that!" said some of the Earthians.

"Actually, it was quite easy, because we realised early on that such non-transparent practices detracted from the collective good," said the Vulcans. "They attenuated responsibility and accountability. Like you, we had not updated the basics of our obsolete stock ownership system for more than a century, and it had become backward technologically and subject to abuse for tax evasion and other illicit purposes."

#### **Curtailling 'limited liability for free'**

"Next, we realised that the concept of governments' conferring unfettered 'limited liability' to shareholders 'for free' was also not logical. It allowed companies to raise huge amounts of cash, which all too often enabled them to profit from activities that subsequently created massive negative externalities – loss, pain and damage to society. In the vast majority of these cases, shareholders and executives could just walk away from the scene, largely unscathed, their own liability and losses being limited to the money they had paid for any stock they held. But the price they had paid often was infinitesimal compared to the magnitude of the externalised damage. As a result, society and individuals simply had to absorb the damage that those companies had created on an uncompensated basis.

"On Earth, cases in point would be the opioid, asbestos, or tobacco crises; Enron and Tyco; your oil companies now going bankrupt; or the exploitation of credit derivatives that led to your global financial crisis starting in 2008. Vulcan had its share of unfair societal outcomes like those, just like Earth. It had become clear that unfettered limited liability in an age of huge institutional investors and massive equity markets had become a sort of 'free ride' that was actually distorting incentives in the wrong direction. And, after each disaster, there was a long-time lag until appropriate regulations were put in place, if ever.



**"On Earth, cases in point would be the opioid, asbestos, or tobacco crises; Enron and Tyco; your oil companies now going bankrupt; or the exploitation of credit derivatives that led to your global financial crisis starting in 2008."**

"Put simply, by giving corporations unrestricted limited liability – something that had become immensely valuable – 'for free', our civilisation was accelerating its own demise. It also did not make sense that shareholders be able to escape all future risks just by selling shares, when many of them had elected the current board, which oversaw present policies and would continue on after they sold."

Some of the Earthians demurred, saying: "But limited liability is what makes it possible to raise funds needed for investment in innovation to address the challenges modern society faces. We can't just go back to the way things were in 1800, before the industrial revolution."

"We are not suggesting that," the Vulcans patiently replied, "because obviously, social institutions are path dependent. But what you *can* do, is to modify your market framework so that responsibility and accountability are built into its incentive mechanisms, better reflecting society's future needs – looking towards 2080, not the 1880s.

"We want to help you, as others helped us. So, we have summarised the type of steps we took to redesign our market system, framed the context of your laws and terminology. Please read it and ask us any questions you have. We can only spend limited time here."

The summary was entitled: *'How We Saved Our Planet'*. The introduction read as follows:

#### **Transparent ownership and stewardship set the base**

"Transparency of ownership and tracking of stewardship via voting and engagement activities disclosed by active investors, were essential in our redesigned market system. These aspects maximized visibility, accountability and incentives at all levels of the investment chain. Stewardship quality became much more sensitively reflected by the market value of companies and the reputations of executives, asset managers, and asset owners. Until we did this, our investment chain was a chain of compounded agency problems and accountability gaps – just as yours is now.

We abolished almost all anonymous holding of shares or beneficial interests in them. Each share or beneficial interest became a distributed-network blockchain token that recorded every historical legal holder and ultimate beneficial owner over time, and the transaction details, every time it was traded. This data was made universally available in the case of institutional investors' holdings in all public companies and large private companies. All other types of equity shares or equity-type legal interests benefiting from limited liability, were abolished."



## Aligning incentives for profitable sustainability was the key

"We re-intensified the standardisation of sustainability-related disclosures that were specific to each industry and sub-industry, including dependable verification methods, and required all such disclosures be made in completely machine-readable format, so they could automatically track and be compared - even the text explanations, using AI techniques.

"We agreed upon global taxes for things like carbon footprint, water use, pollution, and non-biodegradable plastics - that is, for the easily-tracked factors upon which we were absolutely certain our civilisation's survival depended. We also prohibited all political contributions from corporations.

"At the same time, we explicitly acknowledged that because we could not predict future technological or social changes 25 years from now, we could not now clearly identify the other ESG factors that would most impact future corporate and global sustainability.

"Unless we could time-travel ahead and then return to the present, this was inevitable. We therefore concluded that ESG investing, by itself, would not be sufficient to save our civilisation. Even defining 'more optimal governance practices', the all-important driver of ESG, was extremely difficult. Defining governance 'excellence' and 'true substance' (not just 'form') in organisations is very hard.

"Most importantly, we recognised that the persons who were best positioned to identify and prioritise corporate and systemic sustainability, were the directors, executives and employees who worked at each company or investment fund, but only if they were incentivised to do so.

"Right now, your capital market system does not do this. From our point of view, most compensation or fee structures in your investment chain provide the wrong incentives."

# 1

"We recognised that on Vilcan there were generally three types of investors: (a) active 'Type A' investors, who could afford to spend sufficient time doing proper analysis, trading, engagement, and governance via voting, and did so on their own account or were paid enough to perform that role; (b) 'Type B' investors, individuals and fund managers (often, passive fund managers) that could not necessarily be expected to perform those roles with as much dedication but could benefit from the engagement activities and proxy-voting set by respected Type A investors; and (c) 'inside' investors who worked at each company, whether directors, executives or employees, and therefore had special insights and information about that company."

# 2

"Each corporation over a certain size was required to issue two classes of equity shares, each corresponding to at least 40 per cent of total cumulative capital raised: (i) Class A shares, which entitled the owner to its pro-rata share of residual assets in bankruptcy, full voting rights, and full rights to benefits such as dividends or buybacks; and (ii) Class B shares, which traded separately and entitled the owner to full rights to dividends or buybacks, and had claims in bankruptcy that were prior to the claims of Class A holders."

# 3

"Directors and executives who were 'inside' investors were required to hold (and were only permitted to hold) Class A shares, in an amount that was equal to at least 30 per cent of their total cumulative compensation as executives at the time of each grant, and were not permitted to sell that '30 per cent' accumulated portion of shares during their employment or for a period of seven years after their retirement. (They could, however, freely buy and sell shares exceeding that 30 per cent minimum level - thus providing invaluable information to the market.) Non-executive employees were paid at least 10 per cent of their total income in Class A shares - more if they chose to do so - and were required to hold them for at least two years."



# 4

"An 'insurance levy' of 0.15 per cent was withheld from the amount of all transfers or issuance of any class of stock. This forced investors to pay something for the immense benefits of limited liability and easy transferability of shares that governments had granted them when companies were incorporated under their laws. The 0.15 per cent funds went into an 'externalisation/bankruptcy escrow fund' set up for that company and were invested in Treasury bills. The more often the stock was issued or traded, and the larger the company's market capitalisation, the larger this fund grew."

# 5

"Non-insider Class A investors could sell their stock anytime they liked, but for seven years after selling, each stood to potentially 'lose' a certain percent (or all) of the total amounts they had 'paid' into the fund with respect to shares, in the event of liquidation or bankruptcy. During that seven-year period, those funds stood available to creditors and victorious lawsuit claimants in the event of bankruptcy or liquidation of the company....in other words, they were available to compensate for losses in cases such as opioid or asbestos crises, or bankrupt overleveraged investment banks, and including any class action settlements in cases where the corporate assets were insufficient to pay claims."

# 6

"The exact percentage of each Class A share's 'trust fund interest' subject to potential loss depended formulaically on how long (in aggregate) each investor had held the stock, which is to say, the approximate time span during which they could have voted or engaged with management differently. For example, investors who had held stock for five years were penalised more than investors who had held for only one year, since they had had greater opportunity to monitor and correct the behaviour that may have led to bankruptcy or the failure to liquidate the firm earlier in time. However, to prevent 'gaming' of the system and unfair outcomes, in this calculation all Class A stock was presumed to have been held for at least one year, even if it had been held for only one day. Likewise, the maximum holding period was assumed to have been seven years, even if it had actually been longer."

# 7

"If there were no bankruptcy or liquidation during the seven years following the sale of a Class A share, each investor who had held that share received back its 0.15 per cent amount(s), plus interest. Non-insider Class A shareholders could also vote to use the portions they had paid into the fund for settlements that were needed to avoid bankruptcy. In the case when non-insider shareholders voted to liquidate the company, if there were funds left over after paying creditors, Class A shareholders received the remaining portions of the funds in escrow (after any payments to Class B holders), depending on their percent allocation. Therefore, they had a strong incentive to 'pull the plug' and act soon to stop risk-externalising actions, or to act before corporate prospects became significantly worse for other reasons. However, in any of these cases, as necessary the entire portion withheld from directors and executives was always tapped before any other pro-rata apportionment."

# 8

"In contrast, Class B shareholders had claims in bankruptcy, reorganisation, or liquidation that were prior to those of Class A holders, but did not stand to receive back any of the 0.15 per cent amounts they had paid. In this manner, they simply 'paid' up-front for the right to receive full limited liability, easy transferability, and a superior position in bankruptcy."

**"In any of these cases, as necessary the entire portion withheld from directors and executives was always tapped before any other pro-rata apportionment."**

# 9

"Any type of general investor – whether an individual, actively-managed fund, 'passive' investment fund, ETF, trust, or any other type of investment vehicle – could choose to hold either Class A shares or Class B shares, depending on its confidence in its own engagement and voting capabilities or its ability to assess the abilities and dedication of others.

However, all board members and executives of investment vehicles or trust funds were required to comply with the same rules as those for corporate executives: they had to hold fund interests in portfolio companies' A shares (or the fund itself) in amounts equal to at least 30 per cent of their total cumulative compensation and were not permitted to sell those investments during their employment or for a period extending seven years after their retirement. As you say on Earth, 'what is good for the goose is good for the gander.'"



"Class A shareholders were the most motivated to be diligent in this respect, as they had the most 'skin in the game'. They stood to reap significantly greater returns than Class B holders if they held a stock for many years, performing detailed analysis before and after investment, assiduously engaging with that company, and voting to appoint directors and executives who (post facto) maintained its profitable sustainability and ethical corporate culture. In that case, after seven years they would almost always receive back all of their 0.15 per cent escrow portions, plus interest. This boosted their reputations as asset managers or asset owners over time because their abilities were substantiated by irrefutable statistics that were constantly updated.

"In addition, a significant portion of shareholders had usually traded in and out of the stock during previous years, thereby increasing the size of the escrow fund 'cushion' available to investors in superior companies. This became a form of 'insurance fund' for that firm - which if it was large, lowered its cost of capital. Short-term holders increased the size of this fund, and only enjoyed superior returns when they could generate significant alpha."

"Trading by short sellers also increased the fund's size, partially offsetting the impact of short-selling and further reducing volatility. If the fund grew very big, any portion in excess of 50 per cent of market capitalisation could be donated to a non-profit cause, but only if a majority of all shareholders approved. In particular, because they were at the very bottom of the totem pole in case of bankruptcy or liquidation, directors and executives at all levels of the investment chain had strong incentives to think and act more like true long-term residual owners, as they should, rather than elite insiders entitled to getting a better deal than other shareholders.

"Stock prices became less sensitive to short-term financial results and other factors, and more sensitive to 'non-financial' factors that had suddenly become much more visible, dependable, and comparable. For instance, share prices rose at companies where there were many institutional investors who were proven by transparent historical data to be truly dedicated to engagement and electing qualified, dedicated directors, and where there was high-quality disclosure related to sustainability."

## "Stock prices became less sensitive to short-term financial results and other factors, and more sensitive to 'non-financial' factors that had suddenly become much more visible, dependable, and comparable"

"In contrast, share prices declined at companies where many Class A holders were less dedicated stewards and more short-term in mindset, and appointed less diligent directors. Moreover, employees at such firms tended to sell all their shares after two years. Thanks to the completely transparent system of share ownership we had created, all other investors could track those employee sales (as a category), in addition to sales made by executives, as well as monitor the quality of the Class A investor base. Any purchases or sales by executives of shares exceeding their 30 per cent minimum holding requirement, were especially closely watched - and were required to be immediately disclosed. Both provided additional indicators for prospective shareholders of any class - including future potential employees - and improved the reliability of our AI-assisted new systems for analysing industry-specific and value-relevant ESG data that was standardised, comparable, and machine-analysable.

"There were countless other synergies. Stock market volatility and volume both declined, but that was mainly because there was less short-term churning by 'volatility investors' who added little to the quality of the market, and because stock lending to short-sellers decreased. ETFs holding Class B shares increasingly focussed on AI-based indexes that changed gradually over time, based not only on fundamentals, traditional ESG factors, and third-party sentiment analysis, but also on ownership analysis, including the level of director/executive and employee holdings.

"Voting by Class B funds was scrutinised and rated as to quality just as much as voting by Class A investors. All of this enabled excellent companies to raise funds and increase their escrow 'cushion' at the same time, by issuing Class B shares at lower cost. At the same time, a variety of 'long-term engagement' mutual funds investing in Class A shares emerged, with portfolios composed of carefully selected stocks that were infrequently sold.

"We had succeeded in 'leveraging' incentives for companies and investors to either: a) put in the time to find the optimal path to profitable sustainability; or b) if that were not possible, to liquidate the company 'sooner rather than later' and before it might be unable to pay creditors and other stakeholders, might externalise risks, or might become subject to harsh but necessary regulation."



### What About Earth?

Our success was possible because we recognised early on that having the right sort of truly long-term 'skin in the game' as an incentive or disincentive, and complete transparency about ownership and voting, were essential.

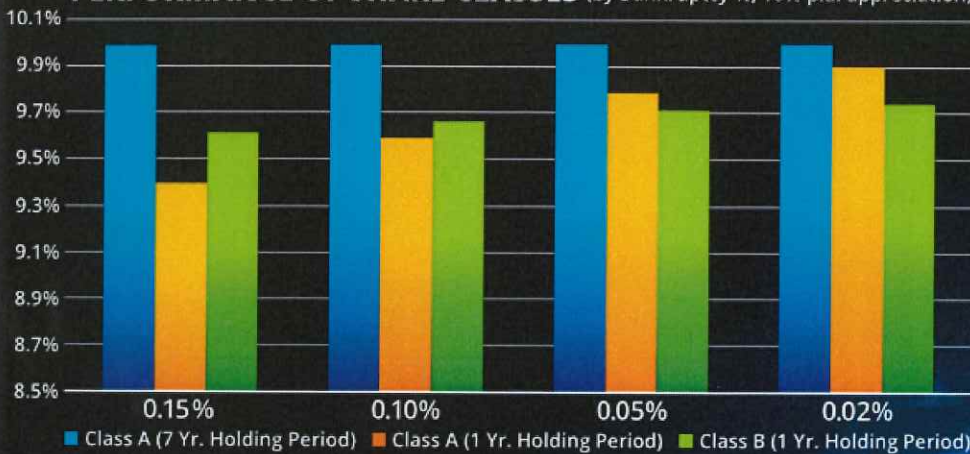
In contrast, if we may be frank, because of your different traits as a species, we are not optimistic of your chances. Why is it that you persist in believing that the current incentives in your system are sufficient? On Earth, right now ESG and impact investors could be establishing new types of companies that use the same types of motivational levers that we put in place. Why are ideas like these not even being discussed?

It seems to us that many of you care more about increasing your personal wealth than the continuation of humanity. That is not logical. How do you plan to spend that wealth? To whom will you leave it when you die?"

#### The steps Planet Vilcan took:

- Abolished anonymous ownership
- Curtailed 'limited liability for free'
- Tracked past holders and time held
- Levy on stock trades to insure society
- Centralised data on stewardship, voting
- Executives made accountable via very long-term IC
- Investment chain also subject to very long-term IC
- Standard-format, comparable disclosure
- Entirely machine-readable by AI
- Carbon, water and other taxes introduced

### PERFORMANCE OF SHARE CLASSES (by Bankruptcy %; 10% p.a. appreciation)



#### ABOUT THE AUTHOR

Nicholas Benes is CEO of the The Board Director Training Institute of Japan (BDTI), a Japanese non-profit. A lawyer and MBA who worked as an investment banker at JP Morgan and then led his own M&A advisory boutique, Nicholas has served on a number of Japanese boards and Japanese government advisory committees. In 2013, he proposed that a corporate governance code be included in the Japanese government's growth strategy, and suggested many of the new code's principles.