THE CASE FOR POWERFUL SHAREHOLDERS

Robert A.G. Monks

Governments should affirm that creating an effective shareholder presence in all companies is in the national interest and that it is the nation's policy to aid effective shareholder involvement in the governance of publicly owned corporations.

Photo above: A shareholder asks questions during the Level 3 Communications, Inc., annual shareholders' meeting in Omaha, Nebraska, in 2003. Such meetings provide a forum for investors to air their concerns. (©AP/WWP Photo/Nati Harnik)

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In the United States for nearly 80 years, lawyers and jurists, in particular former Supreme Court Justice Louis D. Brandeis, have taken the lead in expressing concern about the widening separation between shareholders and corporate management and the resulting abuse of corporate power. The same concerns were expressed by Adolph Berle and Gardiner Means in 1932 in their book *The Modern Corporation and Private Property*. The prescient concerns of all these pioneers were well summarized in 1970 by legal scholar James Willard Hurst:

> Stockholder surveillance is the principal internal factor on which tradition relied to legitimate corporate power. … The continued willingness of our citizens to have privately chosen corporate leaders make decisions affecting production, employment, and quality of life has been countenanced because of the accountability of these leaders to the corporate owners. In our view, the practical erosion of stockholders' voting power undermines the very structure

of private enterprise upon which our national economy and political life rests.

Ceding Power to Investment Institutions

Corporate shareholders have involuntarily, indeed largely unconsciously, relinquished powers to corporate managements. This trend follows from the marked rise of tax-incentivised institutional investment, and it has left an ownership vacuum at the heart of shareholder capitalism. Hence the resultant abuse of managerial powers and, inevitably, a backlash against business.

Investment institutions, lacking the ability to control corporate managements, fall back on the strategy of holding a wide spread of shares combined with a high share turnover. Shares are regarded like betting slips on unforecastable races. Thus, shareholders have long been "punters," or gamblers, rather than "proprietors."

The essence of any system of governance is that those to whom major powers are entrusted must be accountable to those whom they serve; otherwise, self-interest will prevail to a greater or lesser degree. American shareholder capitalism fails this test. The accountability that exists is typically limited and delayed. Managements are not effectively accountable either to individual shareholders or to the investment institutions and fund managers that are the intermediary agents of the ultimate shareholders. Nor, in turn, are these intermediaries effectively accountable to the ultimate shareholders—the individuals who are pension fund members, and policyholders. There is thus a double accountability deficit, which inevitably results from passive, absentee ownership. This is the fundamental weakness of shareholder capitalism, and it must be effectively remedied for all other weaknesses to be resolved.

It is a basic tenet of free market capitalism that the system rests on the effective ownership of private property, that is, that owners choose how their assets are used to best advantage. It is thus particularly unsatisfactory that the largest single category of personal property—stocks and shares (including the beneficial interest in stocks and shares held collectively via investment institutions, mainly to provide retirement income)—should lack effective ownership. Those who hold shares directly—in America, 50 percent of all shares are held directly—are individually so insignificant as to be virtually powerless. Those who own shares beneficially are even more powerless. (A beneficial owner is one who enjoys the benefits of owning a security or property, regardless of whose name the title is in.) Only if shareholders can unite effectively—and in practice this applies only to institutional shareholders—will corporate managements be held accountable. This seldom happens save in a rare corporate crisis, by which time the damage has been done.

"This is the part of capitalism I hate."

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Passive Pension Funds

In America, the tradition of individual investment remains strong, with half of all shares owned personally. Most of the rest are owned by life insurance companies, mutual funds, and direct benefit pension funds, whereby companies invest to provide staff with pensions. Under powerful tax incentives introduced in 1970—the 401(k) plan, a retirement savings plan funded by employee contributions and often matching contributions from the employer—employers are switching to direct contribution schemes. An American employer's contribution can be and frequently is paid in the form of its own shares. For example, many employees at Enron held more than 50 percent of their retirement funds in their own company's shares. In many mega companies, such as General Electric and Coca-Cola, the proportion is 75 percent, and in Proctor & Gamble, it is more than 90 percent. While a company is stable and growing, this seems acceptable, but for employees' jobs and pensions alike to be tied to a rising share price is dangerously risky.

Increasingly, most employee contributions to 401(k) schemes go into a wide spread of shares; sometimes the employer's contribution does as well. Mutual fund firms compete heavily for this huge business. Their corporate

governance activities, if any, will thus have a crucial effect on both the level of pensions and American corporate governance.

There is to date no tradition of corporate pension fund or mutual fund corporate governance activity. The sole occasional exceptions are some of the larger public sector pension funds, which are in no way beholden to corporate managements. (An honorable example is the College Retirement Equity Fund—CREF.) Thus, in America, opposition to very high executive remuneration or the routine repricing of share options is almost unknown, as is regular direct pressure on failing chief executive officers (CEOs) to resign. There is resentment but realistic recognition that shareholders lack the power to do much about it. American CEOs frequently lose their jobs because of short-term performance failures, but this is due to market pressures, not shareholder activism. Whether recent corporate scandals will cause lasting change remains to be seen.

Corporate pension funds, controlled by their corporate managements, have almost never been activist. There is an implicit understanding that each company's pension fund will refrain from an activist stance in return for a reciprocal stance from all other pension funds because corporate managements prefer to discourage any form of corporate governance intervention to their mutual benefit. As for life insurance companies, banks, and mutual funds, they are, respectively, in competition with their peers, and hence cooperative action is comparatively rare. Many are parts of wider groups also seeking banking or insurance business. Many own fund managers and so are additionally wary of antagonizing corporate managements.

There is an explicit duty on all these institutions to be proactive investors on behalf of their beneficial shareholders—indeed, it is trust law in the United States, albeit seldom enforced. But that collective action, which alone could be influential, is rare, and it is largely confined to cases of gross underperformance, usually over many years, or after very serious corporate management misconduct, by which time it is too late.

Fund Managers: Conflicts and Short-Term Expectations

The constraints that make the investment institutions largely passive owners apply equally to the individuals known as fund managers. These investment specialists manage the funds of the investment intermediaries—particularly pension funds—few of which are managed internally. Most mutual funds manage their own funds. More than 75 percent of fund managers are owned broadly equally by investment banks and insurance companies. Most insurance companies usually invest not only their own very large funds (principally of policyholders) but also corporate and public sector pension funds, making them both direct institutional investors and fund managers.

Investment provisions are always agreed with clients, but fund managers have the prime responsibility for choosing the strategy best suited to client needs. They unquestionably exercise great power in determining investment decisions. Top fund managers and specialists are among the highest paid people in America, with salaries at least equal to those of most senior corporate managers. The management of the major pension funds of America's top 500 companies (more than 75 percent of the stock market) is highly concentrated on the top 10 fund managers. They, thus, compete fiercely to attract and retain major corporate business, inevitably reducing their scope for holding corporate managements accountable.

The inability of fund managers to hold corporate managements, who are their main direct or indirect paymasters, accountable inevitably causes them to seek risk diversification by holding very wide spread share portfolios, the reaction of a punter rather than a proprietor. This process, as noted earlier, is compounded by the fact that the managers' clients expect funds to perform well over only relatively short periods. This highlights one of the most significant weaknesses of shareholder capitalism: the serious mismatch between the periods over which fund managers are judged and the rather longer periods, say, five or six years, that would better suit most beneficiaries. Client pressures inevitably cause fund managers to favor shares expected to perform well on a short-term basis, a phenomenon that has caused many commentators to blame fund managers for share bubbles and collapses over the last four years.

Breaking the Cycle

There is a harmful and destructively intensifying process at work here whereby optimal long-term corporate performance is damaged and with it the interests of most investors. Thus, there are few incentives for fund managers to take as long-term a view as their investment skills justify, or corporate managers as their strategic management skills justify. At the same time, fund managements blame corporate managements

fund managements blame corporate managements *collectively* for putting them under undesirable short-term pressures and vice versa. Breaking this vicious circle is one of the most important challenges for corporate governance reform.

Governments should affirm, in support of the fundamental principle that there should be no power without accountability, that creating an effective shareholder presence in all companies is in the national interest and that it is the nation's policy to aid effective shareholder involvement in the governance of publicly owned corporations. A national-level council should be created to ensure that this policy is applied by all executive and judicial branch agencies, competition authorities, stock exchanges, and other similarly involved entities. ■

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