

CORPORATE GOVERNANCE – PAST, PRESENT AND FUTURE

Robert A.G. Monks

November 10, 2009

Francis Fukuyama published “The End of History” in 1992, styling the fall of the Berlin wall as the termination of a long period of competitive ideologies and nations. There appeared from this half millennium evolution an unending and global accord of political democracy and market based capitalism. Over the following fifteen years, particularly in the United States, the values of the market prevailed under the rubric Globalization which provided a measurement language based on maximization of transactions. Market power, incarnated in the transnational corporations, increased its influence over competing considerations to the point in the Bush Administration where it was virtually the only voice, with disastrous results. Cost / benefit calculations, which excluded consideration of externalized liabilities, were skewed changing both the persona of corporations and the character of those who served them.

The prevailing theory has been that a co-operative interrelationship between involved owners, fiduciary directors and government would provide sustainable standards and effective implementation. Within this framework, we have all been involved in the struggle to affect, influence, reform “market place” values. What we had thought was a global harmony of democracy and the market places turns out to have been merely a new iteration of the struggle for power with its traditional characteristics of concentrated wealth and public poverty. Alan Greenspan has becomingly acknowledged his failed philosophy - "I made a mistake in presuming that the self-interests of organizations, specifically banks and others, were such that they were best capable of protecting their own shareholders and their equity in the firms." And so, the dream of the private participants in wealth creation managing their affairs to accommodate public welfare has failed.

We have now come to the End of the End of History.

The prolix Judge Richard Posner illumines: “but although the financiers bear the primary *responsibility* for the depression, I do not think they can be *blamed* for it – implying moral censure – any more than one can blame a lion for eating a zebra. Capitalism is Darwinian. Businessmen take risks (mostly within the law) the promote their financial interests; it would make no more sense for an individual businessman to worry that because of the instability of the banking industry his decisions and those of his competitors might trigger a depression than for a lion to spare a zebra out of concern that lions are eating zebras faster than zebras can reproduce”¹

The irresponsible use of power by Chief Executive Officers is the primary cause of failure of a private corporate governance regime. Can they be blamed for asserting power to control the board to which they are nominally accountable, dominating the process by which their compensation is determined, the accounting rules by which their performance is evaluated and using corporate resources to prevail in government debate over resource allocation in a “free” society? No matter the private morality of the cadre of corporate directors, no board generated by a self perpetuating process can achieve the objectives fixed by statute or by the demands for a private system of effective governance. Three quarters of registered shareholders are fiduciary institutions. Since 1975 fiduciaries have been permitted to have public owners and transferable interests, thus locking in a conflict of interest causing the trustee to prefer the economic fate of its own shareholders rather than the beneficiaries for whom it is responsible. Indispensible to the collapse of private governance has been the failure of government at all levels – executive, agency and judicial - to enforce existing laws, importing including those prohibiting just the conflicts of interest that have crippled ownership.

Corporations are about creating wealth in a manner satisfactory to the requirements of the chartering domicile. This started with Royal Charters and special charters for specific public works. Overtime, the definition of public interest was diluted to the point of mere recitation. In different countries, the relationships between corporation and state, wealth and public authority are expressed differently under changing conditions. But, the

¹ Posner, Richard, [A Failure of Capitalism](#), (Harvard 2009) at p. 284

legitimacy of corporate power depends on the perception and reality of the the independence and hegemony of governmental authority. In the United States, the geometrically increasing levels of lobbying and corporate expenditure in political elections challenge any notion of legitimacy. The notion that artificial legal entities organized to facilitate the transaction of business and the accumulation of wealth should have constitutionally protected rights that the Framers believed came to human beings from their Creator has even less credibility today than in 1978. Certainly the amorality of corporate America has only become clearer since Justice Powell gave corporations political rights. In most other countries, the superior power of the state is acknowledged, but one needs examine the specific circumstances to decide whether the state has become the creature of the financial interests. Certainly, the experience of the US and the UK “too big to fail” financial sector evidences just this phenomena. The state has, in effect, been held hostage by the self inflicted wounds of a few prominent companies.

Corporate governance in all countries is based on the division of power and responsibility between public and private authorities. Elected authority has full power with respect to proscribing standards with which private entities are obliged to comply. Private wealth creation is deemed to be in the public interest so long as corporations obey the law, inform the public about the corporation’s impact on society and minimize corporate involvement in politics. This theoretical triad actually forms an interrelated and self-reinforcing conceptual basis for corporate accountability and legitimacy. In different countries at different times, there are departures in practice from the necessary elements of a legitimating structure. Corporate governance based on relationships between owners, directors and managers is not the pattern which will prevail under circumstances, like those prevailing today, in which there is significant direct government involvement as owner and creditor.

There is vast agreement that Corporate Governance failures are responsible in large measure for the financial disasters of the last several years. Consider from the UK. “The Treasury Committee Report provides an answer in the affirmative. . . “Institutional Investors have failed in one of their core tasks, namely the effective scrutiny and monitoring the

decisions of boards and executive management in the banking sector, and hold them accountable for their performance.”²

Five years ago, in addressing this class, I made suggestions as to ameliorate the governance deficiencies of shareholders, directors and executive officers. The context has changed – we are no longer talking of a voluntary rearrangement of the prerogatives of components of the corporate structure, we will be confronted by specific new governmental regulations – the scope of which is still unclear. We have learned how expensive dysfunctional governance is. We must learn from our mistakes, not just repeat them.

We can no longer blindly accept the received wisdom as to the roles and responsibilities of owners, directors and CEOs. Categories simply do not perform as advertised. While there is general understanding of this, proposed remedies have persisted in dealing with these classes, as if their traditional categorization was real. We need to express clearly how each has functioned during this crisis period, how that functioning departs from the “conventional wisdom” and what remedial steps can be taken. It is naïve to think and act as if the current arrangement of power is not satisfactory to many who hold it. Our efforts will be a struggle for reallocation of that power.

The vast majority of institutional owners today decline to be responsible for the functioning of companies whose shares are held in portfolios, for the management of which they have fiduciary obligation. In the case of banks, mutual and pension funds, the explanation is conflict of interest. In the case of universities and foundations, it is a bit more subtle - there is a disinclination to disturb existing profitable relationships.

The core problem has been the disappearance of any practical or legal respect for the fiduciary standards that ensure a beneficiary of the loyal competence of the person responsible for managing his property. We have tolerated conflicts of interest throughout the commercial system with the result of enriching service providers and impoverishing

² House of Commons, Treasury Committee, Banking Crisis: Reforming corporate governance and pay in the City, 12 May 2009 # 179.

beneficiaries. Worse, this regulatory neglect has placed the conscientious fiduciary at a competitive disadvantage.

We arrive at the current place where “activism” is not generally attractive, either from the perspective of value adding incentive or of avoiding discipline or fine for fiduciary failure.³ Simply, the “carrot” is not sufficient inducement and the “stick” is insufficiently daunting. The result is that – with a few honorable exceptions -TIAA/CREF in America, BTPS and Hermes in the UK – activism has been limited to union and public employee pension funds, which – notwithstanding their virtues – do not appear to have the experience or orientation necessary to act as credible maximizers of shareholder value. In sum, only the least credible tranche of shareholdings are prepared to act for the class as a whole; the preponderance – for their own reasons – prefers non action.

This systemic dysfunction necessitates the involvement of an external catalyst – government. Only government can definitively locate the responsibilities of shareholders – shares loaned, shares sold short, shares whose vote is contracted away from the economic beneficiary, and – not least – Government as shareholder – UKFI. There is need clearly to place responsibility for stewardship on one of the parties in the fiduciary chain. The pattern of trustees delegating functions is well established; often the voting responsibility is de facto delegated to a voting service. If active ownership is to serve its intended purpose, there needs be a single responsible body. Nor can a US or UK regime bind institutions with domiciles elsewhere. As the Walker report duly notes, a voting regime can only be imposed on UK domiciled funds. “The aim is to embed commitment to the Principles of stewardship (on a “comply or explain” basis) on the part of UK-authorized entities and thereafter to encourage voluntary participation by SWFs and other non-resident investors on the basis that this is likely be in their own interest and in that of their clients as ultimate beneficiaries.” {5.40}

³ An honorable exception is the late Alastair Ross Goobey, who, while CEO of Hermes Investment Management, devised a business scheme pursuant to which those to whom he was responsible were enriched at the same time as his subsidiary activist funds, initially Hermes Lens Asset Management, introduced activism into the UK market place. His view was that index investors have no choice but to allocate assets to assuring the continuing integrity of the market place in which they invested.

Short term activists – arbitrageurs, “locusts”, hedge funds – need no encouragement. Their business model rewards thrusts into the market place. We are left with two components of potential long term activists – the unthinking index and computer shareholders and the activist portion of McKinsey’s “intrinsic” holders. They have very different characteristics. The index funds are in competition with active managers for the portion of investors funds allocated to equity. One of the principal competitive advantages they have is lower costs. If the index funds are to be an element in the activist shareholder of the future, some economic arrangement will be necessary in order not to prejudice their competitive posture. Their perspective will inevitably be systemic. Following the guidance of Alastair Ross Goobey, they will relate to the market place as a whole, they will not usually focus on individual companies. Alas, there is no clone of Alastair. We will need overcome present reluctance of indexers with carrot or stick. The intrinsic holders, by contrast, will focus on individual companies. Probably, their incentive structure always needs to be reconsidered. Do we want two kinds of activism? And if not, which one?

It must be clear that amidst the panoply of stock ownership, there is a difference of kind between those who invest through impersonal mechanism and those whose investments are a matter of sentient choice. Lord Myners suggestion of two classes of stock might well reflect this difference. A further dichotomy might be drawn between those shareholders – passive and active – who chose to function as stewards and those who do not. Again, dual classes of stock might be appropriate. It is well to remember that when Warren Buffett invests in marketable securities, he is usually able to secure a special classification that reflects the value added by his involvement. Nor has the dual class prevalent in Scandinavia lowered long term equity returns. Even American scholars comment favorably on such a notion: “Providing long-term shareholders a greater number of votes per share should become a permissible option.”⁴

Further improvement would result from the determination that stewardship, being in the interest both of the corporation and of society, is appropriately an expense of the

⁴ Lipton, Lorsch, Schumer’s Shareholder Bill Misses the Mark, WSJ, 5/12/9

corporation. If a sum is to be made available for those willing to undertake the costs and exposure of stewardship, there would be reduced difficulty is enlisting the index funds to perform the key long term role. It might well be that this is the best answer, as what is wanted is both long term stewardship and a perspective for the investment world as a whole, in contrast to individual companies.

This paper asks the question:

- Is there genuine commitment to an ownership based governance system? [It must be said that no such commitment exists at present.] This commitment will need be made by government. If so

The paper suggests two main policy initiatives:

- There must be effective enforcement of existing law so as to require fiduciaries to take appropriate action to protect and enhance the value of portfolio securities, and
- There must be arrangement for financing “activism” either as an appropriate corporate expense or as a designated portion of the investment management fees.

Peter Drucker has long raised the question as to whether the current standard of board functioning is so unsatisfactory as to require structural change. - “Whenever an institution malfunctions as consistently as boards of directors have in nearly every major fiasco of the last forty or fifty years it is futile to blame men. It is the institution that malfunctions.”⁵ In the years subsequent to Drucker’s characterization, the inability of any portion of the governance structure to deal effectively with holding top management to account - the “smoking gun” being executive compensation - compels the conclusion of continuing systemic board failure. If the shareholder cannot hold the CEO accountable for his compensation, he has no right to assume that he exercises effective accountability in any other area. Analysis of previous board malfunction is virtually overwhelmed by the insistence on yet larger majorities and more extensive definitions of “independent” - “At

⁵ Drucker, Peter, “The Bored Board,” in Towards the New Economy and Other Essays, (Harper & Roe, New York 1981), 110

present the consensus view as to corporate governance best practice is so dominant that it is difficult even to suggest that further empowerment of an independent monitoring board may not be the solution to the current round of corporate scandals and flagrant abuses. Nevertheless, after watching independence and empowerment ratcheted up and up and up for 30 years, our conclusion is that enough is now enough. It is time to recognize that other best practice models of corporate governance need to be evaluated..... The point is that by turning the corporate board into the ‘monitor’ of corporate management, we do not appear to have been able to stop the scandals and flagrant abuses, and we may well be losing the vision, advice, and competitive perceptiveness that a good board should be providing the CEO. Surely there must be better ways to deal with the consequences of the separation of ownership from control in the modern corporation. The time has come, we believe, to think outside the consensus box.”⁶

Corporate America has opposed even a scintilla of suggestion that shareholders participate in the nomination of board candidates. Former SEC Chairman Donaldson’s proposal for token shareholder involvement was so plainly unsusceptible of leading to the election of a director that one is bewildered by the violent rhetoric of opposition. The usual reason adduced for this vehemence is the essentiality of maintaining the confidentiality and collegiality of board functioning. Sherlock Holmes would look further, but we need not do so here.

Perhaps, it is time to recognize that a fundamental and irreconcilable conflict exists in the perception of what boards should do and how they should be constituted. Our efforts to achieve functionality within the context of the traditional single board can be understood as the metaphoric inability to square a circle. We cannot hope to make progress until - once and for all - we face up to the reality that a self selecting board cannot ever meet the very real needs for independence at critical points in the governance structure. At the risk of offending Aristotelian purists, let me attempt a syllogism:

⁶ Ibid, at 78

Independent directors are essential to good governance;

Directors selected pursuant to a self selecting process cannot be considered in any meaningful way to be independent;

Therefore, good governance requires something other than a board of self selected directors.

The desired objective can be achieved through the enactment of a pre-emptive federal statute conferring on ten percent of voting shareholders the right to call a special meeting at which a majority acting can remove any or all of the directors with or without cause. (The UK model)

The contrasting realities are:

- Major shareholders can, without provoking undue controversy or potential legal exposure, agree that there should be change in a board of directors.⁷ Substantially greater commitment and exposure is required to get agreement as to the particular individuals who should be proffered as replacements⁸.
- Institutional shareholders have no particular competency to select individuals to serve as director in specific situations.⁹ They can, however, readily acquire the capacity to evaluate board changes proposed by management.
- Change does not mortally challenge management who retain the power to nominate directors.¹⁰ This continuing prerogative is importantly balanced when shareholders have non controversial power to remove directors.

⁷ Institutional investors would as a matter of “due diligence” have an opinion as to whether change is necessary in a particular company; the process of identifying particular individuals to take the place of particular directors involves substantial time, legal exposure and expense.

⁸ My annual fees of some \$50,000 to file a “plain vanilla” §14 (a)(8) resolution with a hostile Exxon Mobil gives some hint as to the administrative complexities and legal costs of effecting a nomination filing under the various access proposals. Who, as a practical matter, is going to incur these expenses?

⁹ As special counsel in the settlement of many shareholder litigations, I have had experience in selecting new directors. I have a lot of humility about my role. In the UK, over ten years with Hermes Lens Focus Fund and Governance for Owners, I witnessed the creative tension that exists between a credible shareholder and management in the selection of particular directors.

¹⁰ Outsiders cannot have the necessary knowledge of the chemistry and experience of the board, so as to be able to make optimal suggestion as to desirable changes in the composition of a board. Empowered shareholders can require management to justify their recommendations.

- A creative tension exists – management must ultimately propose nominees satisfactory to the shareholders who can effectively express opposition without undue exposure. This impresses as the right result.

If we have achieved the informed involvement of fully participating institutional investors in a governance system which empowers the accountability of directors to owners, there is little need to pursue specific limitations on the power of the principal executives.