

**A REVIEW OF CORPORATE GOVERNANCE IN UK BANKS AND OTHER FINANCIAL
INDUSTRY ENTITIES**
**Response to Chapter 5 – The Role of Institutional Shareholders:
Communication and Engagement**

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“What is wrong with the British and American system is that far too many shareholders, both institutional and individual, do not behave like owners.” *The Economist*, May 5, 1990.

How far have we moved, if at all, from this state described by Rupert Pennant-Rea twenty years ago? The Treasury Committee suggests there has been inadequate progress, if indeed there has been any.¹ The Walker Report addresses the policy considerations underlying institutional responsibility which he styles “stewardship”. {5.7} The potentially highly influential position of significant holders of stock in listed companies is a major ingredient in the market-base capitalist system. It needs to be accorded an at *least implicit social legitimacy*. As counterpart to the obligation of the board to the shareholders, this implicit legitimacy can be acquired by at least the larger fund manager through assumption of a reciprocal obligation. This obligation should in particular involve attentiveness to the performance of the investee companies over a long as well as a short term horizon. On this view, those who have significant rights of ownership which enjoy the very material advantage of limited liability should see these as completed by a duty of stewardship. “(emphasis added) To Shareholders in a typical public company in America or Britain – call it Anglo-Saxon Inc – a share is now little more than a betting slip. It is bought at what a shareholder thinks are good odds, to provide winnings that he hopes will be large. The notion that he owns part of Anglo-

¹ 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.” House of Commons, Treasury Committee, Banking Crisis: Reforming corporate governance and pay in the City, 12 May 2009 # 179. “We also believe that ne of the most important lessons from the crisis is that institutional investors responsible ownership needs to be strengthened in order to be fit for purpose. UNEP Finance Initiative, Fiduciary Responsibility, July 2009, p 11.

Saxon Inc makes as much sense to him as it would the average gambler to imagine that he owns part of Lucky Lady, running in the 2:30 tomorrow afternoon.”²

Today’s consolidated US/UK shareholder roster typically shows 30% of the outstanding shares are invested in index mode and a further 20% are invested pursuant to a variety of computer-driven algorithms, generally in the search for value anomalies among various industries, companies, and currency denomination. In both these cases, choices are made by mechanistic formula and do not reflect a human being’s decision to buy or sell. Another 30% of investors know the stock market solely through their friendly broker. Although brokers are of all kinds, they are paid if their customers buy or sell, the more frequently the better. None of these groups has the long term, informed engagement with their holdings necessary to be activist owners.

So, quite quickly, we are left with 20% of the total who might be thought of as real proprietors and even potential activist investors. These are the owners who consider the long-term disposition of their funds; who follow the conduct of their portfolio companies; and who are prepared, if necessary, to take steps to assure that defects in the governance or strategy or execution by managements are addressed. In the simplest terms, these are the only shareholders who actually know the companies in which they hold shares. McKinsey, the premier consulting firm for corporate management, describes these “intrinsic investors,” {5.30} as basing their decisions on a deep understanding of a company’s strategy, its current performance, and its potential to create long-term value. We can begin, at this point, to appreciate Lord Myners recent suggestions about the possible desirability of two classes of stock – that, ironically enough echo Proprietors & Punters.

However, even this one investor in five who may be considered a real owner is furthered diluted by the dirty little secret of benign neglect of conflict of interest. Let’s briefly re-screen the major categories of institutional investors from the perspective of activity *encouraging conflict of interest* and thus *inhibiting responsible activist ownership*.

- A “golden rule” among company executives at corporate pension funds goes as follows: My pension fund will leave you alone so long as your pension fund leaves me

² *The Economist*, op.cit.supra

alone. In the United States, there has never been an activist intervention by a pension fund governed by ERISA. *Never.* For its part, the U.S. Department of Labor has an unblemished record over the last twenty five years of *not* bringing suit against a fiduciary having conflict of interest for failure to monitor portfolio companies.³ I am unaware of any government action otherwise in the UK.

- Most trustees at public pension funds are appointed or elected and are thus both politically vulnerable and politically conflicted. Why would any company locate new jobs in a region that uses its pension resources to oppose management?

- Conflicts abound equally for financial service firms. Why would any company go out of its way to talk with analysts from an investment group company that does not support it? Why would a “focus company” hire such investment group to run its retirement program?

- Banks and Insurance companies have a myriad of sometimes conflicting connections with companies, the securities of which they hold in trust accounts. Often the financial importance of the trust arrangement is substantially smaller than that of the other business concerns.

- Many of the trustees of our august universities and foundations depend on the favor – collegial, psychological, and financial – of the enterprises whose securities comprise their endowment.

Passing from institutions to the leading individual investors, the “collective action problem” is daunting. Warren Buffet recently said “when we own stock, we are not there to try and change people”⁴. Warren “rescued” Solomon Brothers as a minority owner. While he made an adequate return, the overall impact of his effort was to make money for people whose conduct caused the problem in the first place. The Gates Foundation professes no interest in activism. Volunteering to be a leader of shareholder activism created unwelcome problems of publicity and conflict of interest for Fidelity’s Ned Johnson; Lloyd Blankfein, CEO of Goldman Sachs, says simply -“it doesn’t make

³ United States Government Accountability Office, PENSION PLANS Additional transparency and other Actions Needed in Connection with Proxy Voting (GAO-04-749 August 2004)

⁴ Global Edition of the New York Times, May 9-10, 2009

business sense for us or for our customers.” Frank Cahouet⁵, then CEO of the UK owned Crocker Bank, wrote me on August 17, 1995; “We are very reticent to position ourselves as an activist shareholder in domestic or international securities. The problem for us is how we are perceived by our customer base. The risks are such that it probably does not make sense for us to take an aggressive position. I can imagine many of your partners do have a lot more freedom since they apparently no other business interests with portfolio companies.” Can Cahouet’s concern for his customers’ reactions be fully met by “*implicit social legitimacy*” for activism, or will more be required – like legal obligation – in order to assure a level playing field among competitors? Alan Greenspan speaks for the conventional wisdom: “After considerable soul-searching and many congressional hearings, the current CEO-dominant paradigm, with all its faults, will likely continue to be viewed as the most viable form of corporate governance for today’s world. The only credible alternative is for large — primarily institutional — shareholders to exert far more control over corporate affairs *than they appear to be willing to exercise.*”⁶ The emphasis is mine, added to demonstrate Greenspan’s apparent ignorance of fiduciary law. He writes as if obedience to the law is a discretionary matter for fiduciaries. Therefore, activist fiduciaries would be perceived as “volunteers”, almost “officious intermeddlers” if they depart from the conventional. Yet Greenspan does, however inferentially, confirm the right place to begin.

The core problem has been the disappearance of any practical or legal respect for the fiduciary standards (even for Frank Cahouet, a profoundly ethical man) 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 beneficiaries. Worse, this regulatory neglect has placed the conscientious fiduciary at a competitive disadvantage.

⁵ In the interest of full disclosure I gratefully acknowledge that Frank Cahouet, later CEO of Mellon Bank, has been a friend and classmate for the last 65 years. I know of no one with greater personal integrity. I will use his name throughout this memorandum in order to personalize the difficulties that fine people, responsible for fiduciary institutions, encounter under the present regimes of failure of enforcement of fiduciary duties.

⁶ Greenspan, Alan, Remarks at the Stern School of Business, March 26, 2002

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.⁷ 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 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}

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

⁷ 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.

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 focused on individual companies. Alas, there is no clone of Alastair. We will need to 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?

The Institutional Shareholders Committee ("ISC") is comprised of industry based associations of institutional investor. Whether of not a particular fiduciary is an insurance company or a pension fund or a mutual fund is not germane to its appropriateness as an activist investor. Each institution will inevitably have holdings that are indexed, that are manager by computer program. Most will have some intrinsic investors. The ISC has no particular credibility or competency in being responsible for passive or intrinsic shareholder activists. While there have been instances in the past of ISC activity focused on particular companies and there have been leaders – Mike Sandland of Norwich Union and Donald Bryden in his Barclay's days come to mind – with ambitious agendas, overall it has been rare that the ISC has committed substantial time or resources to governance challenges. In light of the incongruence between the institutional classification of its component members and the nature of the two kinds of potential activists, it must be questioned whether ISC is the appropriate agency to carry this work forward.

The threshold question must be whether we feel stewardship objectives can be achieved within the current framework of "comply or explain" or whether significant alterations will need be made to the incentives and penalties governing the on going system. There are such a myriad of conflicting considerations that new transcending and binding resolution has appeal. We have to deal with real problems – how is our hypothetical honorable chief executive going to reconcile stewardship with his

customers' reasonable expectations if there is not unequivocal requirement that his competitors comply with the same requirements. How are we going to induce those institutional categories, strangling in conflict of interest, without legal insistence that they act as stewards solely in the interest of their beneficiaries? Is it fair to impose a burden of additional expense on "stewards" without making possible a reallocation of rewards?

Does the critical voice have the ring of truth? "Unfortunately, Walker's proposals lack teeth and risk becoming nebulous when economic health returns and investors must look to prevent the next crisis, not cast an eye over their shoulder at the last. What will they really achieve in seriously promoting long term investment? Where is the 'incentive' for the ultimate shareholders – the institutional investors – to become owners with their eyes fixed firmly on durable returns and their service providers clearly aligned in this direction also? (nb. Fund manager votes against corporate management remain pitifully low).⁸

With Allen Sykes, I have elsewhere⁹ articulated four comprehensive proposals in aid of a system of effective stewardship:

- 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 so as to ensure authorities, stock exchanges and other similarly involved entities.

- All pension fund trustees and other fiduciaries (insurance companies, mutual funds,) holding shares must act solely in the long-term interests of their beneficiaries and for the exclusive purpose of providing them with benefits. The scope of required shareholder activism is to ensure, on a continuous basis, the functioning of an appropriate board of directors.

- To give full effect to the first two proposals institutional shareholders should be made accountable for exercising their votes in an informed and sensible manner above

⁸ Hugh Wheelan, We must incentivize long-term investment to help prevent systemic risk, Responsible Investor, August 4, 2009. <http://www.responsible-investor.com/home/article/systemic/P1/>

⁹ Capitalism without owners will Fail – A policymakers guide to reform. Centre of the Study of Financial Innovation.

some sensibly determined minimum holding (\$15m/£10m). Votes are an asset (voting shares always have a market premium over non-voting ones). Accordingly they should be used to further beneficiaries' interests on all occasions. In effect, the voting of all institutionally held shares would be virtually compulsory.

- To complete and powerfully reinforce the other three proposals shareholders should have the exclusive right and obligation **to nominate** at least three non-executive directors per major quoted company.

Our conclusion is that involvement by the full spectrum on institutional investors – without which the legitimacy of ownership activism is seriously diluted – is only possible through explicit legislation and commitment to enforcement by all branches of government. Allen Sykes and I speak to the “stick” aspect of incentivizing institutional stewardship.

Our approach can be expanded (and improved) by focusing a bit on the carrot side. I have cited often the “Punters or Proprietors” article in *The Economist* of twenty years ago. It may be that the passage of two decades has managed to change a conjunction and today the answer is Punters AND Proprietors. 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.”¹⁰

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

¹⁰ 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 in 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.] 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.