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Honorable Lawrence H. Summers
President & Fellows of Harvard College
President
Harvard University
Massachusetts Hall
Cambridge, MA 02138

Dear Larry,

Re: To Harvard With Love

In a speech at Aspen in July 2003, you famously characterized the challenge for education as persuading students to "do the right thing. It has long been a cherished prerogative of Harvard graduates to volunteer advice to President and Fellows of Harvard College. In approaching the fiftieth anniversary of my graduation from Harvard College, I have considered the usual expressions of gratitude. Indeed, I have made some traditional gifts in the past, especially our Follen Street home thirty years ago when we moved to Maine. I prefer now to give the gift of words, writing about a subject of importance to the College and to me. I ask Harvard to take the lead as the responsible owner of equity securities in most publicly traded corporations.

Why write about corporate governance? There are two reasons: only owners can effectively assure corporate functioning compatible with the welfare of citizens and governance is the long term key to returns on investment. The dramatic recovery of stock market levels as of June 30 will bring a welcome sense of relief, but we should use the interval to prepare for the next downturn. Once untouchable, endowment funds were tapped more and more to cover expenses in the first years of the new century. In 2001 this trend hit Harvard hard. Following a second consecutive year of negative returns, Harvard paid a big $749 million from her endowments to cover *nearly a third* of operational expenses. The returns were (0.5%) for the year ending June 30, 2002 and (2.7%) for the year earlier. Jack Meyer, Chief Executive Officer of Harvard Management "thinks the current rate of distributions from the endowment is sustainable, assuming investment returns of 6 percent or so above the rate of inflation – implying nominal returns of 8 to 9 percent."[i] Over long periods of time, a 6 percent real rate of return, although not unrealistic in light of the demonstrated success of Meyer's tenure (12.5 over the last five years[ii]), nonetheless is a difficult target to reach. How to ensure success in reaching that goal? The particular category of assets promising consistent returns at that level is the ownership of business enterprises. Harvard's financial future depends in large part on the existence of a healthy "equity culture".

Equity Culture

Many elements must coexist at the same time in order to provide a nurturing environment for a healthy "equity culture." Perhaps the most important of these is a psychology — a culture, if you will — that accepts risk and failure as positive factors. Europe with her hierarchal structure in both public and private life, lacks such a culture, what we Americans still call the "old country" attempts to insulate its people against high-risk hopes, emphasizing the importance of formal

education, and offering apprentice programs for blue and white collar workers. There is no place in such a system for the “bold experiment” that fails, and so to a significant degree the benefits of equity culture have largely missed continental Europe — and Japan, as well, for that matter.

Equity markets also need a fully articulated legal system that respects the rights of property. Owners must have reliable and quick access to courts or administrative apparatus in order to vindicate their rights. Indeed, Hernando DeSoto explains the absence of wealth in Third World countries as a function of failure of individual land ownership.[iii]

Equity culture requires fully developed and trusted capital markets, funded in significant part by institutions capable of investing in a range of enterprises — from the riskiest startúup through to the surest of mature companies. Fortunately, such institutions do exist and are involved in building our equity culture. Today, a majority of the equity in this country and in the world is held by institutions — including institutions like Harvard.

Ownership of a large publicly held corporation is more complicated than ownership of land, buildings, and other tangible objects. What is actually owned is a piece of paper — a share certificate — entitling the registrant to a variety of rights provided under applicable laws, including the expectation of benefits. In recent times, the chain of ownership has become further attenuated, as certificates are registered in the names of nominees to facilitate transfer to custodians for security.

In the case of charitable organizations where legal title rests in one party, such as President & Fellows, further complications arise. In such cases the nature of “beneficial ownership” is diluted to the limits of comprehension. Who exactly is entitled to the usufruct of Harvard’s endowment? Clearly it is not the donors of the property, for they are not “investors” in the corporate sense. Their gifts come, or should come, without strings. Yet the donors, as such, should have some say in directing the yield of their gifts. Should it go to today’s students? Today’s faculty? The students and/or faculty of tomorrow? With these four possibilities alone, permutations are many. (Even assuming that all four options are chosen, there are 24 ways to combine and prioritize them, if my ancient algebra serves.)

This President & Fellows example returns us squarely to the question of beneficial ownership in the publicly held corporation. Is it the faculty, today’s students, tomorrow’s students?

ut a century ago, the great corporation scholar John P. Davis, pointed out that shareholding in public companies was a modality different from that of conventional ownership. In his introduction to Davis’s book, my corporation law professor at Harvard Law School, the late Abram Chayes summarizes his theme:

“Ownership fragmented into shares was ownership diluted. It no longer corresponded to effective control over company operations. Shares became investments, claims on earnings, themselves the object of ownership and of ready purchase and sale. They signified less and less a traditional owner’s relation to productive assets. Business decisions gravitated to small boards of directors, the members of which no longer held office by virtue of major investments in the company, and which were under no significant outside control or supervision.”[iv]

Davis himself “gives up the ghost” of ownership in the face of this dispersion — great indeed diaspora — of wealth. In his view, a loss of involvement should trigger a loss of power. Davis says that if a shareholder is nothing more than a passive recipient of income and of relatively modest capital gains from steady growth, then he should not claim from law the kind of concern that might be appropriate for a more active and responsible participant in corporate power.[v]

This certainly makes sense for investors whose rights derive merely from computer programs or indices bereft of choice or responsibility. But what about the property rights of the involved owner? In my view, there is a correlation between the rights of ownership and the involvement of owners. A fully realized equity culture depends on shareholders' involvement. Shareholders must exercise their rights, or those rights will atrophy. As I have suggested elsewhere[vi] it is not necessary that all shareholders be involved. What is necessary is that enough ownership involvement be evident to create a climate of accountability. "Shareholder capitalism" in the United States today has been trivialized because the most learned and respected institutional investors – the universities and the foundations – have conspicuously declined to be associated with the effort."

Having a healthy equity culture is important. It not only helps determine whether Harvard can afford to exist at the style it would like, but also helps shape whether society as a whole is wealthy or poor.

Harvard's experience with equity investment circumstances are a metaphor for those of society as a whole. Much emphasis has been placed on the creation of private wealth over the last fifty years. It should be noted that during this same time, funds have accumulated in protected trust portfolios to pay for the expense of retirement living. This wealth creation could not have occurred without a healthy equity culture, together with investor's decisions to invest in stocks rather than bonds, a rising stock market, and supportive tax policies.

Equity culture can be expressed as a matter of arithmetic. The real rate of return on corporate ownership over the last century has been approximately 6 percent — Meyer's target for tomorrow; the rate of return on bonds after inflation is 2 percent. The impact of this difference on a compounded basis over twenty five years is dramatic. With an initial investment of $1 million, equities will be worth $4.3 million but bonds only $1.6 million. Imagine the same difference, multiplied by tens of thousands. Clearly the difference between these numbers can shape whether a society is rich or poor.

The Importance of Corporate Governance in an Equity Culture

Investors will not purchase securities if they lack confidence in the reliability of the information they receive concerning those securities. Markets will not attach attractive values to listed companies in the absence of a climate of trust.

This climate is sadly lacking today not only because of the failure of auditors to enforce the truth, but also because of the desire on the part of many CEOs to hide it while they enriched themselves. History will look back on the 1990s as a time when the principal officers of public American corporations transferred from shareholders to themselves approximately $1 trillion — or 10 percent of the market value of public exchanges. This must be the largest peacetime movement of wealth ever recorded, and it was accomplished through stealth that amounted to theft.

At the beginning of the decade roughly 2 percent of the market value of listed companies was represented by options, at the end the figure was up to 12 percent.

How could this transfer go undetected? One might ask. Couldn't the shareholders see that this was happening? The fact is that they could not see it, because accounting rules did not permit them to see it. In 1994, the Business Roundtable, an organization consisting entirely of the CEOs of large public companies, successfully pushed through a Senate resolution by 88-9 (on May 3, 1994) to declare that "in the money" options were **not** a corporate expense, and did not have to be reflected in the company financial statements. The Financial Accounting Standards Board, which had labored for years under Chairman Dennis Beresford, to require this expensing, had to capitulate to the lobbying pressures that infamously included the SEC and the Council of Institutional Investors.

The profits from these "stealth options" were the instrument of CEO enrichment. It will be a long time before the markets trust CEOs to run companies in the interest of shareholders again. As the option expensing example shows, the capacity of corporate leadership to intervene in the workings of the market creates a further and more serious threat to trust. Those who, like President & Fellows, benefit from markets perceived as being honorable will need expend resources to help ensure those markets' integrity.

There is substantial agreement that those having the power to mine corporate wealth in the form of pay must be accountable to some independent and competent group. Only the owners can perform this function, and they are, understandably, if short sighted, reluctant to do so.

Alan Greenspan, the Chairman of the Federal Reserve System, recently shed a great deal of light on this matter.[vii]

"In a further endeavor to align boards of directors with shareholders, rather than management, considerable attention has been placed on filling board seats with so-called independent directors. However, in my experience, few directors in modern times have seen their interests as separate from those of the CEO, who effectively appointed them and, presumably, could remove them from future slates of directors submitted to shareholders...

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*." (Emphasis added.)

Greenspan trenchantly dismisses many years of naive reliance by scholars and law and code writers on the almost theological characteristics of the "independent director", on whom the whole system of legitimate corporate power was supposed to be based. The problem is, as Greenspan revealed, that the phrase "independent director" is an oxymoron. (Maybe that explains the continuing fervor with which the concept continues to be refined, most recently by the New York Stock Exchange.) To paraphrase Abraham Lincoln, if you talk enough about five-legged dogs, many people will begin to see them.[viii] No member of a self-perpetuating organization can be held in any meaningful sense to be independent of that organization. Primary loyalty will always flow to the organization and its continuance rather than to some outside abstraction such as ownership.

Greenspan's conclusion that we are left to the mercies of corporate executives is made more in the spirit of a "*faute de joueurs,"* a win by forfeit rather than a true victory.

Greenspan does not appear eager to rely on CEOs. Yet had he looked further, he would have seen a superior alternative. The Fed Chairman based his conclusion on the proposition that institutional owners are not a viable alternative base for governance *because they choose not to be*. This notion is at best debatable. Institutional owners cannot get out of their fiduciary responsibilities so easily. These are defined under existing federal laws respecting pensions (Employee Retirement Income Security Act of 1974), mutual funds (Investment Company Act of 1940), and banks. It would be a novel twist, indeed, for a fiduciary to be free unilaterally to decline to protect the value of trust property. This would be manifestly contrary to law and tradition. Employee benefit plan trustees are obligated to involve themselves in the affairs of portfolio companies to the extent that this involvement is necessary to preserve value.[ix]

Can all holders of publicly traded stock comfortably assume that someone else will take up the burden of guaranteeing a level of integrity in market functioning that alone will ensure the possibility of optimum values?

Former SEC Chairman Harvey Pitt went so far as to state that "money managers should view their corporate proxy votes as a fiduciary duty." Could not the same be said of university endowment funds? Let us turn to the example of Harvard.

Harvard's Traditional Posture With Respect to Corporate Governance

Harvard is the very substantial owner of the publicly traded stocks of large businesses. President & Fellows created the first, and arguably most successful, (until Yale's recent heroics) special-purpose investment vehicle — Harvard Management Company — for the purpose of maximizing the long-term value of its assets. Harvard Management is a fully competitive entrant in the field of money management and pays world class wages to its professional employees.

Harvard has become an "owner" of virtually all of those enterprises whose collective functioning impacts life on earth perhaps more than any other institutions. The question is the extent of Harvard's responsibility as owner. What is Harvard doing now? Does she ensure optimum value? What should she do in the future?

These are not theoretical questions for Harvard. In the fall of 2002, you were confronted with a petition urging that "universities ought to use their influence — political and financial — to encourage the United States government and the government of Israel to respect the human rights of the Palestinians" by divesting from Israel and from American companies that sell arms to Israel.[x] In response to such an issue, seminars would be used to draw wisdom from your penultimate predecessor, Derek Bok.

President Derek Bok once lamented that his entire Presidency was dominated by the question of "divestiture" of shares in companies whose activities greatly displeased one or another of the University's many vocal constituencies. Between 1979 and 1987 Bok published a number of "open letters" to those many constituencies, analyzing the complex and heated campus issues of the day. "Reflections on the Ethical Responsibilities of the University to Society" (1979) set out what had to be taken into account when the University was asked to take a political stand. "Reflections on Divestment of Stock in Companies Doing Business in South Africa" (1979) explored the option on a contentious question as did his "Open Letter on Issues of Race" (1981) and "Reflections on Free Speech" (1984) focused on the investment issue.[xi]

President Bok codified what I will call Harvard's policy of "institutional deference" to the status quo:

"As I have already observed, society respects the autonomy of academic institutions because it assumed that they will devote themselves to the academic tasks that they were established to pursue. This does not mean that the universities should refrain from trying to influence the outside world. It does mean they should exert an influence by fostering the reasoned expression of ideas and argument put forward by their individual members and *not by taking institutional steps to inflict sanctions on others*. Universities that violate this social compact do so at their peril. They cannot expect to remain free from interference if they insist on using their economic leverage in an effort to impose their own standards on the behavior of other organizations." (Emphasis added)[xii]

One might well ask how far "beyond" the "ivory tower" President Bok ever ventured when the path was marked "investments". Not far enough, in my view.

Like your predecessor, you also appear to conclude that Harvard is free to decide unilaterally whether or not it will be accountable for the consequences of its investments. You have contented yourself with "Harvard is first and foremost a center of learning, not an institutional organ for advocacy on such a complex and controversial international conflict."[xiii]

Like your predecessor, you have taken what can only be called an “ivory tower” approach to investing. This approach sounds good on paper, but it is wishful thinking. Corporations and other institutions do not function in a discrete manner. Their interrelationship with society cannot be neatly defined by boundaries, either theoretical or practical; there will always be areas of interactivity.

Harvard has developed a very worldly competency to increase the asset value of its investments. Can one seriously object to her taking worldly responsibility for some of the consequences of her investments? After all, Harvard is one of the largest owners of public corporations; she is not a stranger to their impact on society.

Institutions cannot simply define problems as being external to their mission; at some place “the buck stops” and some institutions have to begin to accept responsibility. The alternative is a chaos where the most difficult problems are simply ignored by those best qualified to help, left to fester in the certainty that they will become toxic.

Harvard must face reality. Our great university exists not in a tower, but in the real world — where businesses have a costly impact.

The Impact of Business on Society and Harvard

Harvard receives funding (via both returns on investment and direct grants) from businesses that shape our world — and Harvard. Businesses are importantly involved in the law making process — from providing critical financing for elections to lobbying lawmakers, regulators and implementers.

Business institutions tend to externalize costs on to the rest of society. This can range from the literal emissions from industrials processed into the air, water and earth to the uncompensated medical implications of dangerous, repetitive and debilitating work.

It bears noting that much of Harvard’s functioning at the present time derives from a co-operative relationship with the business community. Harvard should not let this interest conflict with its greater concern. Businesses are an important revenue source for universities. Support for sponsored research is Harvard’s second largest revenue line at $518.8 million. Although this amount includes federal grants for biomedical science, it also includes some corporate donations.

Corporate hegemony is not the subject of this paper, but if educational institutions do not face this issue — who will?

The Role of Owners

Harvard can benefit from understanding the role of owners in private enterprise — and from fulfilling its role as an owner. The supposed virtue of private ownership was one of the principal inducements for denationalization of key industries over the past few decades in the United States and around the world. In the words of Sir David A. Walker, then executive director of the Bank of England:

“One of the major arguments for privatization has been the difficulty of establishing satisfactory working relationships between successive governments and the boards of nationalized industries of which, until recently, they have been sole shareholders. The counterpart to this observation is that institutional shareholders of newly privatized businesses are expected to be able to establish better relationships with their boards.... It is their *right* and *responsibility* to promote better boards.” (emphasis added).[xiv]

Unfortunately, few individual owners of large publicly owned enterprises wish to volunteer resources to the exercise of this right and responsibility, because each individual owner runs the entire risk and expense of so doing with the prospect only of a pro rata share of any return. This “collective action” problem makes activism by individual shareholders unlikely.

The same problem exists with institutions, but they possess two mitigating qualities. The first factor is their size. Large institutions can bear the collective action problem because their activism can generate enough profit to justify involvement. For example, Hermes, manager of the largest pension fund in the U.K., has created several specialized relational investment funds, generating fees that defray or exceed the cost of the some 47 professionals it employs in the governance field.

The second factor is their status as fiduciaries – owners who have a legal obligation to take action to enhance property value.

The Benefits of Activism

Institutional investors who exercise their rights as owners can add value to their total equity holdings by preventing or reducing loss in cases of mismanagement.

To appreciate the importance and value of shareholder involvement, we need look no farther than the cases of Salomon Brothers and Waste Management.

§ In the first case, “owner” Warren Buffett took direct personal control of an enterprise, characterized as “criminal”, successfully negotiated with the government the continued “parole” of the company, and ultimately realized substantial profits for all shareholders.

§ In the latter case, “owner” Ralph Whitworth of Relational Investors took on the chairmanship of a literally wasted company in order to direct its recovery from massive accounting frauds.

In both cases, the continuing shareholders have profited. Contrast these situations with Enron and Marconi (UK), where the absence of an “ownership” culture cost the investors virtually their entire investment.

As these cases show, activism is much less about finding a genius strategy for a company than about preventing management mistakes from destroying ownership value.

Barriers to Activism

Despite the benefits of activism, many institutional holders remain passive as investors. Private (corporate) pension funds — the largest element — among the institutional fiduciaries — and investment companies — the second largest — decline to be involved in portfolio companies, largely because they have other relationships that they do not wish to jeopardize. It is hard to imagine the CEO of Company X receiving a complaint from fiduciary Y about his leadership, when Y runs his pension fund. Y has conflicting interests, and will most likely choose her own interests over those of beneficiaries of Y’s fund.

The problem of conflicts of interest could be resolved by applying existing law, but this solution remains unrealized. For the past twenty-five years, both the executive and judicial branches of government have failed to enforce the conflict of interest provisions in existing laws, and have tolerated the inaction of the largest categories of shareholder.

This has left, as a practical matter, public pension funds and certain private institutions such as the College Retirement Equity Fund[xv] not only as the leading, but as the only activist institutions in the US today.

A Role for Harvard

President & Fellows (as well as other charitable and educational funds) might well join these investors. First of all, Harvard, while not large, is big enough to support activism. Harvard Management Company already receives fees managing Harvard's equity holdings, from plain-vanilla investments to complex hedge fund partnerships, and those fees are high enough to support a staff of specialists focusing on corporate governance. Furthermore, what President & Fellows lacks in financial size (so desirable for defraying the expenses of involvement), President & Fellows certainly possesses with respect to social "size". President & Fellows can and should respect the ethical and legal requirements of its fiduciary status, including the so-called "law of trusts".

With respect to conflict of interest, the message of law of trusts is clear beyond dispute: Any conflict must be resolved in favor of the beneficiary. This is understandable, since "trusts" — funds held on behalf of beneficiaries — themselves arose in order to provide sustainable future wealth for those beneficiaries. Governments created (or permitted) trusts to provide retirement income and safety for those investing in stock-holding funds. In doing so, they characterized those funds as "trusts", and thereby assured beneficiaries that their assets would be protected from any forces that would abuse their trust — including trustee conflict of interests.

Unfortunately, however, the very governments that encouraged the rise of trusts, and protected their beneficiaries through the law of trusts, have failed to protect trusts by enforcing those laws. Governments permit trustee institutions to be inactive, and most trusts take advantage of this indulgence.

The solution to this problem is simple: The governments that created trusts and trust law must finish what they started by enforcing those laws.

Technically speaking, President & Fellows are not subject to the federal fiduciary laws. Nor is it apparent how the common law of the Commonwealth of Massachusetts applies to an institution chartered in 1636. Nonetheless, by a simple standard of decency, these representatives of Harvard's interests should respect the spirit of the law of trusts by becoming more active as investors. They need not ask how to do this, for they have already begun.

President & Fellows, as the trustees of Harvard's investments have been conspicuously successful in all manner of imaginative devices to increase the value of its equity holdings. Harvard was willing to appear at the annual meeting of Waste Management and to speak out about the management and accounting problems that five years later were the subject of SEC fines and criminal proceedings. In most recent times, Harvard has demonstrated a willingness to confront the Templeton Mutual Funds:

"In recent filings with regulators, Harvard listed a menu of options it may pursue in seeking to narrow what it alleges is Templeton Dragon's 'chronic' discount to net asset value. Harvard said it may pursue several options, including seeking to remove Templeton Asset Management as the fund's adviser; waging a proxy fight; nominating candidates for the fund's board of directors or 'other steps Harvard might at the time believe may enhance shareholder value.'"[xvi]

Through Highfield Capital Management, Harvard has profited from the most sophisticated current iteration of involved ownership.[xvii]

Harvard's recent activism might seem to contradict past President Bok's observation, cited earlier, that institutions should not "inflict" their views on others. Yet Bok's own words could be interpreted to support institutional activism. He wrote:

“It is one thing to vote one’s stock in the manner expressly provided by law and quite another to search for novel ways to generate publicity and exert economic leverage in an effort to influence the behavior of others.”[xviii]

These words can be instructive to Harvard going forward. Read in context, President Bok was admonishing Harvard’s trustees to stick to the enforceable minimum as investors, and to refrain from making waves through new (or, more pejoratively “novel”) actions. Yet read in the light of recent events, he, however, unconsciously shed light on what would become a new path — the path of shareholder activism.

In concert with this vision of activism, Harvard, during President Bok’s tenure, participated in founding the Investors’ Responsibility Research Center (IRRC) to study — and thus lend needed respectability to — shareholder activism.

Harvard’s critical early support of IRRC came at a time of massive student unrest focused primarily on President & Fellows’ unwillingness to divest securities in companies involved in the war in Vietnam:

“In 1972, several universities took the lead in establishing the Investor Responsibility Research Center…., which prepared for its members impartial analyses of the facts and issues involved in each [shareholder] resolution. Over one hundred academic institutions, foundations, investment firms, and insurance companies now belong to the organization. By this device, member institutions share the cost of investigating the facts and identifying the arguments so that intelligent choices can be made.”[xix]

The IRRC connection runs deep, informing the University’s investment choices. For the past thirty years, Harvard has created a formal process for analysis of selected voting issues. Using IRRC information, the Harvard Corporation Committee on Shareholder Responsibility publishes annual reports describing the pertinent issues and the voting resolutions proposed by other shareholders and, from time to time, Harvard herself.

These reports have enabled Harvard to channel different views of varying intensities relating to the most controversial social issues coming up at corporation meetings. But the reports have only a limited impact. Harvard does not list all resolutions; nor does she disclose her criteria for selection. The issues are selected subjectively, leaving open the question as to what issues are omitted and why. This gives rise to the question — What is the real purpose of this process — is it to reveal the most important issues, or to obscure them?

Socially Responsible Investing

This question raised another one — the very definition of “socially responsible investing” (“SRI”). What is it, really? Let’s start with what it is not. SRI is not, nor can it be, a substitute for law-making. Even the most well-intentioned, most elaborately researched conclusions of the “best people”, be they corporate executives, university professors, or philosophers, cannot achieve the importance of “the people”, acting through democratically elected governments. Is this what we have at work here? It is doubtful.

No citizen has delegated to President & Fellows any authority to prescribe acceptable standards for fuel emissions or any other manifestation of corporate functioning. In a democratic society, only those whose authority derives from informed popular consensus can establish legitimate standards defining the balance between corporate and public interest. SRI, therefore, should focus on assuring that portfolio companies obey the spirit and letter of existing law. However, it is not quite that simple.

For the democratic process to work in a meaningful way, laws must be based on information that is as full and accurate as possible. The situation today is often otherwise. In many situations legislators are passing laws in areas where the information is deliberately withheld or distorted by the industry they are seeking to regulate.

In the United States over the last twenty-five years, this has been the situation with a variety of industries. Here are just a few examples:

§ The principal executives of the five leading tobacco companies testified before Congress that their companies had no evidence of a relationship between smoking and cancer.

§ W.R. Grace deliberately withheld information that its products contained asbestos well after the time it was established that this would injure workers.

There is a further need to restrain business in its impact on elections, the making of laws, and their implementation. If citizens believe that laws are being made and enforced not for the public good but for the interest of corporate money and power it will surely destroy a free society. Where are we today?

Microsoft: A Revealing Example of Corporate Influence

Consider the recent example of Microsoft. When the Clinton Administration filed its first suit against Microsoft in the fall of 1997, the company had a one-man lobbying shop with an office above a suburban Washington mall. Company executives considered the Capitol as a largely irrelevant factor in corporate life. Its political contributions were minimal. Microsoft founder Bill Gates was more focused on making charitable donations of personal income (earned legitimately through the appreciation of Microsoft stock) than in trying to use corporate funds to buy political influence. He shied away from political action, and rightly so. After all, isn't business supposed to leave government to the people?

But Microsoft's naïve trust in democracy met with a harsh rebuke in the company's hour of need. In early 1998, the Justice Department and 20 states filed their broad antitrust suit against Microsoft — arguably thanks to persistent lobbying by its competitors and adversaries, and senators from the states where they were located. Microsoft grew up fast. It learned and reacted on a large scale. The company assembled the usual bank of lobbyists and spinmeisters, and made the requisite political payoffs. As they say, the rest is history.[xx]

There is no hero to this story. It is a story of SRI gone badly. It is a model of too much corporate power over government, both in its beginning and in its end.

This is not an isolated example. The press currently speaks without comment on the legitimate expectations of various industry lobbyists following their successes in the 2002 Congressional elections. The Cato Institute regularly reports the increasing size of "corporate welfare" as a leading component in the federal budget. And so it goes….

Who can make corporate social responsibility worthy of its name? The only element in the corporate universe that can effectively restrain management in its dealings with government is ownership — the active engagement of stockholders, including stockholding organizations such as Harvard.

Socially Responsible Investing: A Closer Look

What is socially responsible investing? Real SRI exists when owners change their company along lines of sensitivity to social concerns. To date, owners have not been doing this. Instead, SRI has been passive —involving acts of omission more than commission. The guiding principle has been that socially concerned investors

should refrain from buying stock in companies that have an unacceptable impact on society.

Investors have focused on excluding the bad, rather than choosing the good. Using modern technology for diversification and risk, they have constructed portfolios comprised of “good” companies (companies that are not bad)

The theory is that if enough potential buyers decline to purchase a security that its price in the market will drop, leading, one hopes, to appropriate remediation. It is doubtful that a useful purpose is served by declining to invest in “bad” companies, and by investing instead in “good” (not bad) companies.

The “creation myth” here is the long program of forced disinvestments in apartheid South Africa. It is occasionally cited that Nelson Mandela applauded those who demonstrated concern in this way; it is also widely cited that the great man applauded those companies who continued operations in South Africa with the effort to improve racial working conditions.

Companies who continued to do business in South Africa continued to have strong stock prices, while those who divested suffered. Indeed, horribly enough, the only financial consequences from this well-intended effort that can be clearly calculated are the huge losses of the companies that divested their operations under “fire sale” conditions in response to SRI clamor.

It is also certain that divesting institutions suffered losses. Roland Machold, formerly the much respected Investment Manager for the New Jersey pension funds (later, New Jersey Treasurer), estimated his funds’ losses at half a billion dollars.

SRI Folly: The Problem with Proving a Negative

Philosophers have long taught that one cannot prove a negative. By analogy it is difficult to imagine being able to prove that moving pieces of paper representing minor ownership percentages among classes of owners (the action required under traditional SRI) will have material effect on the conduct of a publicly owned corporation. What is the alternative? Why not direct this same concern and focus this solution at *changing companies from within,* surely this offers a more promising route.

In the United Kingdom institutional investors are now required to adopt explicit, written social and environmental policies with respect to their investments. Institutions are now in effect legally required to become activist with respect to investee companies if this is necessary to enhance value (the “Myners Report”)[xxi].

An Important Lesson for Harvard

True social responsibility is here to stay in England, and Harvard would be well advised to note this trend.

The emergence of true social responsibility in the United Kingdom has come about as a result of ten years of public dialogue, starting with the so-called Cadbury Commission,[xxii] involving managements, accountants, money managers, bankers and government figures. No such high-level discussion has yet taken place in the United States, either in the public or private sector. The continuing unwillingness of the federal government to enforce the law of trusts suggests that leadership must come from elsewhere, if at all.

Once again, the lead appears to come from London. The Institutional Shareholders’ Committee, comprising pension funds, investment companies and insurance companies in the

United Kingdom, has recently published a manifesto for responsible participation in the affairs of portfolio companies:

"Institutional shareholders' primary duty is to those in whose behalf they invest, for example, the beneficiaries of a pension scheme or the policyholders in an insurance company, and they must act in their best financial interests. Similarly, agents must act in the best interests of their clients. Effective monitoring will enable *institutional shareholders* and/or agents to exercise their votes and, where necessary, intervene objectively and in an informed way. Where it would make intervention more effective, they should seek to engage with other shareholders."

The Great and the Good

Where are the "great and the good"? Universities with a mission of teaching ethics and foundations who contribute generously to mitigating the consequences of corporate functioning have been notably inactive as shareholders, notwithstanding fiduciary law and traditions. An indictment based on conflict of interest would not be appropriate, but the interlocking relationships between top corporate and charitable fiduciaries is a reality that must be recognized and resolved.

Harvard has demonstrated the imagination and foresight in times past to create a cost-effective collective action vehicle in IRRC to meet the need for responsible investing. The times are different today, but the need to meet the challenge for a healthy equity culture remains acute.

Harvard cannot survive without investment returns requiring a high quality of governance. Nor can Harvard expect that the leadership for nurturing this governance will come from others. President Bok hazarded a beginning point:

"[O]ne could argue that they should go further and initiate their own proposals for other stockholders to consider. According to this view, ownership carries an affirmative duty to try to improve the behavior of companies from which one derives a profit. As a result, universities should acknowledge a responsibility to exert such influence because they have the prestige to generate stockholder interest and encourage company executives to pay close attention to the resolution… The burdens of initiating resolutions could be extremely heavy…prohibitively expensive for trustees to monitor the performance of all these companies in order to initiate resolutions condemning inappropriate behavior…An institution could also try to reduce the administrative burdens by agreeing to sponsor resolutions only in certain categories or cases of unusual social importance."[xxiii]

Hence my gift — one given out of gratitude. My Harvard education helped inspire me to devote 25 years to corporate governance activism. I now wish to give back the fruit of this gift to Harvard.[xxiv]

Sincerely yours,

Bob Monks

ENDNOTES

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[i] *Harvard Magazine*, November-December 2002, p.54.

[ii] This figure should be higher when the 30 June 2003 results are taken into account.

[iii] *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (Basic Books, 2000).

[iv] Abram Chayes, Introduction to John P. Davis, *Corporations: A Study of the Origin and Development of Great Business Combinations and of their Relation to the Authority of the State*, 2nd ed. (Capricorn Books, 1961) [orig. 1904], p. xviii..

[v] Davis, supra 86.

[vi] Quoted in Robert A.G. Monks, *New Global Investors*, (Capstone, May 2001) p. 118.

[vii] Alan Greenspan, Stern School of Business, New York University, March 27, 2002.

[viii] "How many legs does a dog have if you call the tail a leg? Four. Calling a tail a leg doesn't make it a leg. Abraham Lincoln.

[ix] U.S. Department of Labor, Interpretive Bulletin 94-2, relating to written statements of investment policy, including proxy voting or guidelines, July 29, 1994.

[x] Karen W.Arensen, "Harvard President Sees Rise in Anti-Semitism on Campus," *New York Times*, September 21, 2002, p. A13.

[xi] Morton Keller and Phyllis Keller, *Making Harvard Modern – The Rise of America's University,* (Oxford University Press, 2001), p. 344

[xii] Derek Bok, *Beyond the Ivory Tower – Social Responsibilities of the Modern University*, (Harvard University Press, 1981), p. 289.

[xiii] Arensen, op cit supra

[xiv] Quoted in Robert A.G. Monks, *New Global Investors*, (Capstone, May 2001) p. 177.

[xv] This is the fund unit of the Teachers Insurance Annuity Association – College Equity Retirement Fund (TIAA-CREF).

[xvi] Erin E. Arvidjund, "Harvard Goes Crimson Over Another Templeton China Fund's Discount to Net Asset Value". *Barron's*, December 2, 2002, p. F3. Note: It is beyond the scope of this article to list and explain all the kinds of shareholder resolutions a fund might sensibly support. Harvard's resolutions in this case do highlight some important ones. In particular, director nomination seems imperative as a substitute for the current system of board nomination, which effectively excludes shareholder input.

[xvii] *Institutional Investor*, January 2003, p. 51.

[xviii] Bok, *op. cit.*, note X, p. 289

[xix] Keller, o*p. cit. supra*

[xx] The foregoing is based on and paraphrases a brilliant article by Joel Brinkley, "A Huge Four-Year Crusade Gets Credit For a Coup," *New York Times*, September 7, 2001, p. C5.

[xxi] Paul Myners, "Institutional Investment in the United Kingdom: A Review, March 6, 2001.

[xxii] Cadbury Commission, "Report of the Committee on the Financial Aspects of Corporate Governance, December 1992.

[xxiii] Bok, op cit supra p. 258, 259.

[xxiv] There follows as Exhibit A a comprehensive "Statement on Institutional Shareholder Responsibilities" adopted unanimously in July 2003 by the International Corporate Governance Network, an organization representing global institutional investors
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EXHIBIT A
ICGN Statement on
Institutional Shareholder Responsibilities

Preamble

Millions of households worldwide depend on the growth in long-term value of investments made by institutional shareholders, be it for their saving schemes, life insurance, retirement provisions or otherwise. As trustees of these investments, which may include shares in listed companies, institutional shareholders have a general responsibility to use best efforts to preserve and increase this value. Improving the corporate governance of companies is increasingly understood as an important means of enhancing the long-term value of equity investments. As a result, many institutional shareholders, along with the ICGN itself, have taken steps to outline best practices for the governance of such companies. However, institutional shareholders as a class have an equal responsibility to address their own roles as fiduciaries and owners of equity on behalf of savers.

This ICGN Statement sets out a framework of best practices on the implementation of fiduciary responsibilities in relation to equity shareholdings. As such it is meant to apply to institutional shareholders and their agents around the world. Further, it addresses the entirety of those relations—not just the shareholder's responsibility to vote shares. At the same time, the principles as described herein should be dealt with pragmatically. Different legal systems, different contractual relations and different markets will require different approaches. This Statement describes general responsibilities. Rather than taking these literally, institutional shareholders and their agents should determine the implications for them and consider the suggestions made on how to implement these responsibilities. It will be up to them to decide what action is appropriate in what situation. The Statement further describes how these decisions should be accounted for.

It needs to be stressed that this Statement considers governance and investor responsibilities associated with it not ends in themselves, but means to achievement of optimum interests of beneficiaries. It should not be taken to encourage any form of rote compliance with excessively detailed guidelines that might inhibit the ability to make decisions on the merits.

This Statement outlines the general responsibilities of institutional shareholders and their agents in respect of their shareholdings. In order to facilitate the proper discharge of these responsibilities, shareholders require certain minimum rights. The ICGN intends to develop principles that describe these in a separate document.

A precondition for the proper discharge of institutional shareholders´ responsibilities is, furthermore, a well-functioning fund governance system with adequate checks and balances. Such a system should, for example, safeguard the independence of trustees and ensure that they have available adequate skills and expertise. ICGN will investigate developing global standards of best practice to give guidance to institutional shareholders in that respect.

In this Statement the term “institutional shareholder” includes pension funds, insurance companies, mutual funds and other collective investment schemes. The term furthermore includes those agents to whom the responsibilities as described herein are outsourced in any way, unless the text indicates otherwise. The term “beneficiaries” includes the beneficiaries of institutional shareholders and clients of agents respectively, unless the text indicates otherwise.

I. General responsibilities

1. Institutional shareholders have a general responsibility to ensure that investments are managed exclusively in the financial interests of their beneficiaries, as amplified - where relevant - by contract or law.

2. As a matter of best practice, in discharging this responsibility, institutional shareholders should contribute to improving and upholding the corporate governance of companies and markets in which they invest, with the understanding that institutional shareholders´ policies may indicate *de minimis* limits for reasons of cost-effectiveness or practicability and that they disclose details of all cases where this is invoked. Such limits may include the impracticability or dispropotionate expenses of voting in certain jurisdictions with inefficient voting procedures.

The general objective of these activities is to stimulate the preservation and growth of the companies’ long-term value. Institutional shareholders should judge which actions are suitable and effective to that end, taking into account the specific circumstances of the case at hand.

Appropriate actions to give effect to these ownership responsibilities may include:

- Voting;
- Supporting the company in respect of good governance;
- Maintaining constructive communication with the board on governance policies and practices in general;
- Expressing specific concerns to the board, either directly or in a shareholders meeting;
- Making a public statement;
- Submitting proposals for the agenda of a shareholders meeting;
- Submitting one or more nominees for election to the board as appropriate;

- Convening a shareholders meeting;
- Teaming up with other investors and local investment associations either in general or in specific cases;
- Taking legal actions, such as legal investigations and class actions;
- Lobbying governmental bodies and other authoritative organisations;
- Incorporating corporate governance analysis in the investment process;
- Stimulating independent buy-side research;
- Outsourcing any or all of these powers to specialized agents, for instance in the event the institutional shareholder concludes that it does not have the ability to muster necessary skills in-house.

3. These ownership responsibilities should be dealt with diligently and pragmatically. This Statement, for instance, encourages the support of good corporate management initiatives, as much as opposition to bad ones. Furthermore, as a general rule, institutional shareholders should not interfere with the day-to-day management of companies.

4. However, it is clear that institutions risk failing to meet their responsibilities as fiduciaries if they disregard serious corporate governance concerns that may affect the long-term value of their investment. They should follow up on these concerns and assume their responsibility to deal with them properly.

Such concerns may, for instance, relate to:

- The level and quality of transparency;
- The company's financial and operational performance, including significant strategic issues;
- Substantial changes in the financial or control structure of the company;
- The role, independence and suitability of non-executives and/or supervisory directors;
- The quality of succession practices and procedures;
- The remuneration policy of the company;
- Conflicts of interest with large shareholders and other related parties;
- The level and protection of shareholder rights;
- Minority investor protection;
- Proxy voting;
- The independence of third party fairness opinions rendered on transactions;
- The accounting and auditing practices;

· The composition of the audit- and remuneration committees;

· The adequacy of internal control systems and procedures;

· The management of environmental, ethical and social risks.

II. Voting

1. Voting forms a prominent part of institutional shareholders´ approach to corporate governance. It should be assumed that all votes cast - regardless of their number - contribute to a stronger management focus on the interests of shareholders in the case at hand, as well as in general.

2. To strengthen this focus, votes should be cast on the basis of careful analysis, consistent with an institutional shareholder's well-considered policy and with a view towards improving and upholding the corporate governance of companies and markets. Automatic voting should be avoided.

3. In this respect, voting guidelines need to be adopted to support the applied policy. In developing these, institutional shareholders are advised to take due account of already existing international and national influential standards, including the ICGN´s own Statements.

III. Accountability of the institutional shareholder

1. Institutional shareholders are accountable to the beneficiaries of their investments for the way they execute their ownership responsibilities. To show how they discharge these responsibilities, institutional shareholders should as a matter of best practice disclose to these beneficiaries:

a. Their corporate governance policy outlining how they deal with their ownership responsibilities, how corporate governance aspects are taken into account in their investment policy, and their voting guidelines;

b. How companies in which they invest are regularly monitored, and how they periodically measure and review the effects of their monitoring and ownership activities;

c. An annual summary of their voting records together with their full voting records in important cases, e.g. cases of conflict or controversy. Voting records should include an indication whether the votes were cast for or against the recommendations of company management. The summary should at least include the percentage of shares voted and the extent to which votes have been cast with or against management;

d. An explanation of specific action taken in important cases;

e. A list of all companies in which they are a shareholder, preferably together with the number of shares held;

f. What resources they have allocated to execute their corporate governance policy;

g. In case no (material) resources have been allocated: how they have weighed the various arguments coming to this decision and an indication of what developments would make them reconsider their position;

h. A list of conflicts of interest that may impede an independent approach towards the companies in which they have invested;

i. What procedures they have in place to deal adequately with these conflicts;

j. The names of the agents to which they have outsourced ownership responsibilities together with a description of the nature and extent of this outsourcing and how it is regularly monitored.

2. Disclosures should be made at least once a year on the shareholder´s website and, preferably, simultaneously in or with the annual reports. The shareholder may choose, however, to provide voting records alternatively to requesting beneficiaries at no cost directly on an annual basis. So far as the responsibilities described herein are outsourced by the institutional investor, it should agree with the relevant agent how the disclosures to the beneficiairies of the institutional investor can be safeguarded.

IV. Conflicts of interest

1. Some institutional shareholders have conflicts of interest that could impair an independent approach towards the companies in which they have invested, generally because they directly or indirectly have other actual or prospective relationships with the companies concerned. In all such cases, the institutional shareholder should ensure full transparency as outlined in III.1 (h) and (i) above. Where such a conflict has the potential to harm the interests of the beneficiaries of their investment in the company, they may consider as one possible solution outsourcing the power to perform their ownership responsibility to a separate independent agent or trust company set up for that purpose.

2. Institutional shareholders should also be aware of possible conflicts faced by their agents. If the casting of votes or the performance of other ownership responsibilities is outsourced (whether or not together with asset management), the institutional shareholder should ensure that the agent acts fully independently from corporate management or other conflicting business relationships. The investing institution should ensure, in particular, that votes are cast in an informed manner and on the basis of voting guidelines that are materially consistent with its own. It should furthermore regularly evaluate the performance of the agent on the basis of detailed reports and ensure that the institutional shareholder can override agent decisions if need be. In case of doubt regarding the independence of an agent, the institutional shareholder may consider as one possible solution outsourcing the power to perform the ownership responsibilities to a separate independent agent or trust company set up for that purpose.

V. Other Responsibilities

1. Given the large differences in market development around the world, it is apparent that the implementation of the provisions of this Statement in day-to-day practice will be more straightforward for some institutions than others. However, the ICGN believes that if institutional shareholders take their responsibilities seriously then this can contribute significantly to the creation of an environment suited for solid long-term investment. Therefore, all institutional shareholders are encouraged to establish an action plan working towards full implementation of the Statement´s recommendations as soon as is practicable.

2. Although share lending in many cases is useful and appropriate, there are negative effects and abuses that require attention. The ICGN is committed to investigate developing a Code of Best Practice to deal with these issues. The ICGN will subsequently determine whether this Statement requires any amendments in that respect.

To ensure that the Statement on Institutional Shareholder Responsibilities reflects future developments in the market, the ICGN intends to evaluate the Statement´s relevance periodically.

08/09/2003