CAPITALISM WITHOUT OWNERS WILL FAIL

A Policymakers Guide to Reform

by

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INTRODUCTION

More serious doubts have been raised over the last 12 months about the acceptability of the current practices of Anglo-American shareholder capitalism than in any period since the aftermath of the 1929 'great crash'. The wave of reckless, unrestrained management decisions, corporate scandals and the accompanying plummeting share prices have resulted in a major crisis of public confidence as most people's retirement savings have been severely damaged. Much of the behaviour of CEOs, non-executive directors, auditors, pension fund trustees, investment institutions, regulators, investment banks and their analysts, which was implicitly accepted a year ago, is accepted no longer. Spokesmen for all of these entities, plus leading politicians and the major stock exchanges, are ready to admit mistakes and urge instant reforms. They dare not remain silent or seem complacent. The newsworthiness of corporate governance has changed unrecognisably. From being a rather dry and essentially minor subject, widely regarded as a drag on entrepreneurial dynamism, it is now recognised as being central to public and investor confidence, and hence long-term prosperity. Without good governance and the resultant trust which it underpins stock markets will remain fragile and volatile. In the limit they could help cause a recession.

The marked turnaround in public and investor opinion and the apparent willingness of politicians, regulators, business and financial leaders, stock exchanges, and professional institutes, not only to accept major reforms, but to propose them, may well seem to make another booklet on the subject pointless, particularly one addressed specifically to policy makers and opinion formers. Surely our work of the last decade, manifest in our books, articles, submissions to governments, and the similar contributions of many other reformers such as ourselves, has now been accomplished. That would be true if our many works had been understood and widely accepted. But the reforms now being extensively urged, albeit with many variations and not a little special pleading, are mainly not the fruit of fundamental comprehensive analysis. The many reinforcing weaknesses that have caused the current corporate malaise are not well appreciated or understood. Until they are, the reforms now being urged and in some cases legislated upon, may fall well short of what is needed. Some indeed could compound existing problems or introduce new ones. Reforms proposed in haste represent more an understandable concern 'to be doing something' than fully considered proposals which address the main weaknesses and will stand the test of time.

We therefore make no apology for writing this short but hopefully comprehensive analysis of the causes and nature of the serious current weaknesses of Anglo-American shareholder capitalism. The problems to be addressed are rather more complicated and often of a fundamentally different nature from what is commonly perceived. Unlike many quite recent and often reluctant converts to governance reform, we believe in and hope to demonstrate the existence of a significant *'systemic fault'*. Most participants in the governance debate instinctively reject this notion. ('There are only a few rotten apples in the barrel.') They wrongly perceive it to imply a life threatening condition as if shareholder capitalism is somehow fatally flawed. It is not. It is, however, in need of some carefully considered reforms based on a full understanding of the

weaknesses and their underlying causes. (Criminal conduct is only the excess result of a more generally unsatisfactory system of inappropriate excess powers for CEOs.) In business and economics the words 'systemic fault' describe a *type* of fault, not its degree of seriousness. It implies only that the fault cannot be remedied by the individual actions of the various parties concerned even if all would benefit substantially thereby. Systemic faults require either compulsion or some other external catalyst, frequently a change in law or regulation, if they are to be remedied.[1] They occur when the number of entities involved in a malfunctioning system are relatively large. There may be a large potential gain for the group as a whole from collective action, but there is insufficient incentive for individual action, particularly when many of the entities, for example, fund managers, are in competition. In the case of corporate governance the position could hardly be less favourable to collective action. There is not just one large group that needs to act but several, each with little contact with the others, and in the case of the many millions of individual and underlying beneficial shareholders, none at all. This explains why despite the many worthy attempts at corporate governance reform in the last decade particularly in Britain, achieved too little. The groups' individual incentives and conflicts of interest have proved impossible to overcome by what were essentially appeals for more enlightened behaviour without effective sanctions.

The key example of the systemic fault is what is now widely recognised to be the excessive powers which have been relinquished to CEOs in both Britain and America, powers which a minority have abused. This gradual, unintended and unconscious transfer of power explains why the interests of a relatively small number of CEOs have prevailed against those of millions of individual and underlying shareholders. It also explains why the *latent* powers of scores or even hundreds of investment institutions has not been collectively mobilised to provide effective countervailing power. As we shall show, the individual incentives to action and their accompanying conflicts of interest are simply too great. Effective lasting reforms require that these realities – which are strongly present in both countries - are addressed as well as other specific desirable reforms on auditing and executive remuneration. The exercise of effective ownership has to be made both possible and worthwhile or all other reforms will be handicapped. This will involve modest catalytic government action to free market forces to deliver superior governance.

It should always be a matter of last resort to urge government involvement but in both countries it is accepted by politicians and business leaders alike that some government and regulatory remedial action is required. The task of all reformers is to provide wise, minimal and, in some cases, temporary reforms to address intransigent current concerns. It is with this constraint firmly in mind that we put forward our own modest integrated reform proposals. They are firmly based on our comprehensive analysis of the numerous independent weaknesses and conflicts of interest which comprise the systemic fault in Anglo-American shareholder capitalism. As observers from Adam Smith to Hayek and Milton Friedmann have long observed, no-one looks after assets as well as the owners. Hence, our guiding principle has been to make effective ownership possible, i.e. to re-unite ownership and control. Putting owners in charge of what they own is of course the purest form of capitalism.

This overview survey, by an American lawyer and investor activist and a British businessman, is designed to be read by busy politicians, senior business and financial leaders, regulators, and concerned members of the public. Its brevity for so large and important a subject is made possible because it is based on a much longer website paper with the same headings to which reference can be made whenever fuller detail is required. That paper in turn is largely based on the authors' three recent books[2], plus major subsequent research. Accordingly, footnotes can be largely dispensed with. This survey of Anglo-American shareholder capitalism at the start of the 21st century is not part of the all too familiar declinist literature of recent years. Shareholder capitalism is not on the point of collapse despite the worrying events of the last 12 months. It has developed some persistent, worsening and malignly reinforcing bad habits. Properly understood they admit of remedy. The longer-term interests of all the many separate entities are damaged by the present dysfunctional system which all are powerless to overcome. The key lies in some

integrated reforms including modest catalytic government actions to free market forces to restore the effective ownership of public companies. These reforms would restore the full integrity of Anglo-American shareholder capitalism and hence full investor confidence, prizes well worth the cost of achieving them.

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[1] We are much indebted to the profound insights of the late Mancur Olsen, the multi-disciplined American economist, for his general elucidation of systemic faults. He identified the intractable handicaps faced by any large groups to achieve what is in their collective interest.

[2] (The books are *The Emperor's Nightingale,* Monks 1998 (Reference A), *Capitalism for Tomorrow,* Sykes 2000 (Reference B), and *The New Global Investors,* Monks 2001 (Reference C), all published by Capstone.

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WORST CRISIS SINCE 1929

Threat to equity culture

The Anglo-American share price boom of the 1980s and particularly the 1990s was the longest and highest for a century. Real equity returns averaged well over 15% compared with long-run averages of 7%. Share prices have fallen (particularly this year) by 40% from the early 2000 peak, and remain fragile and volatile. These developments threaten the long accepted equity culture as the dominant investment of choice for retirement funds and other long-term savings

Damaged investor trust

The traditionally higher returns on equities have been based on trust that has been fundamentally threatened by corporate governance failures which extend well beyond the relatively small number of spectacular corporate collapses. The evidence shows widespread neglect of responsibilities by all the main corporate players and disproportionate rewards at shareholder expense.

Three governance failures stand out:

> Lack of transparency. The fear, particularly in America, is that financial data is unreliable and biased. Many senior corporate managers and their outside auditors have behaved improperly, and non-executive director audit committees have frequently proved ineffective.
>
> Lack of accountability. Despite conventional governance codes, the reality is dominant 'imperial' CEOs whose interests have widely diverged from shareholders. Huge remuneration packages have been widely granted bearing little relationship to sustainable corporate performance. (Listed corporate equity holdings by American CEOs have risen in ten years from 2% to 12 % of the total outstanding equity stock.)
>
> Investment institutional failure. The institutions have failed to protect the long-term interests of the tens of millions of their beneficiaries, despite the institutions' huge latent power (50% plus of shares in America and 80% in Britain). Conflicts of interest and in particular their inability to look after their beneficiaries without hazarding their own business prospects arise from their dependence on CEO patronage which has largely neutralised them.

The gathering storm

The crisis so apparent in the last 12 months has been emerging for the last decade. In neither country has public opinion been fully supportive of business. Doubts have been rather stronger in Britain, but the debacle and concerns about Enron and numerous other American mega companies has raised equal if not stronger American worries about where shareholder capitalism is leading and whether modern company law is adequate. The values of big business are now under serious challenge.

Increasing unease

In the United States, for nearly eighty years lawyers and jurists, in particular, former Supreme Court Justice, Louis D Brandeis, have taken the lead in expressing concern about the widening separation between shareholders and corporate management and the resulting abuse of corporate power. The same concerns were expressed by Adolphe Berle and Gardiner Means. The prescient concerns of all these pioneers were well summarised by Hurst:

"Stockholder surveillance is the principal internal factor on which tradition relied to legitimate corporate power…'. The continued willingness of our citizens to have privately chosen corporate leaders make decisions affecting production, employment and quality of life has been countenanced because of the accountability of these leaders to the corporate owners. In our view, the practical erosion of stockholders' voting power undermines the very structure of private enterprise upon which our national economy and political system are based."[1]

In Britain similar concerns have witnessed six major official inquiries in 12 years. In both countries there has been the involuntary, indeed largely unconscious relinquishment of powers to corporate managements. Both trends are consequent upon the marked rise of tax-incentivised institutional investment. It has left an ownership vacuum at the heart of shareholder capitalism. Hence the resultant abuse of managerial powers and inevitably a backlash against business.

Investment institutions, lacking the ability to control corporate managements fall back on the strategy of holding a wide spread of shares combined with a high share turnover. Shares are regarded like betting slips on unforecastable races. Thus shareholders have long been 'punters rather than proprietors'.[2]

The crisis reactions

Spectacular corporate failures accompanied by steep falls in general share prices have caused a sudden and major interest in corporate governance. With many CEOs gaining great wealth while shareholders suffered badly, compliant non-executives, compromised auditors and misbehaving investment banks, and above all, politicians, dared not remain uninvolved still less silent. There has been a spate of hearings and investigations in America, and much legislation to ensure corrections of misleading financial reports and accounts, auditors' conflicts of interest, and inadequate accounting regulations. In Britain, with its major accounting reforms ten years ago, its numerous governance inquiries, the widespread split of the chairmen and CEO roles in most companies, and more recently several direct government enquiries, a fairly well established process has been accelerated. Major governance and accounting reforms are thus happening in both countries.

The way companies are governed will now change markedly. But will the changes suffice to reassure badly shaken public confidence. There is no guarantee that the often rushed diagnoses and the consequent hurried proposed remedies will really work. Until very recently there has been a pervasive acceptance of the *appearance* of governance. That complacent view is not longer defensible in the light of recent events. It needs to be remembered that every damaging short-term policy, every excessive and inappropriate executive remuneration package, and every accounting scam was either approved or condoned by allegedly independent non-executives. Very few institutional investors have ever challenged these practices effectively, or in time.

The case for *real* governance, however, is now being made. Confirming and expanding their earlier studies, Mckinsey's most recent studies[3] now show strong support from both the majority of American non-executive directors and 200 leading global investors from the 31 major investing countries for corporate governance reform and rebuilding the integrity of shareholder capitalism.

These findings are powerfully reassuring and confirm impressive support for the reform efforts now under way by the American and British governments, their various regulators and stock markets. To put this support to good effect the need is to consider first the serious weaknesses of the present governance of Anglo-American shareholder capitalism.

THE SERIOUS WEAKNESSES

Market capitalism cannot fulfil the requirement of allocating resources efficiently if shareholders – individual, institutional and beneficial – accept *de facto* disenfranchisement of their powers,

leaving important decisions almost wholly to senior corporate managements with conflicting interests.

The major inappropriate powers of corporate management

Effective capitalism requires that corporate managements have wide executive powers *and incentives* to develop and execute strategies in the long-term interests of shareholders. To meet this requirement the wider interests of customers, suppliers, employees and the community must be met for shareholder profits are the residual after meeting these prior claims. Corporate governance, properly understood, is a process of effective accountability of managements to informed and active owners. At the heart of our concern for the state of Anglo-American shareholder capitalism is that chairmen/CEOs and their executive director (senior management) colleagues have at least six major inappropriate powers giving rise to serious conflicts of interest. The corporate managements:

choose their “independent” non-executive colleagues;

choose the “independent” auditors who are also usually consultants with consultancy services averaging several multiples of audit fees (shareholders automatically support board recommendations on these two matters which comprise“ co-erced ratification” of what should be shareholder chosen monitors of corporate managements);
choose the remuneration consultants for the non-executive ”independent” remuneration committee (usually the company’s own appointed remuneration consultants with loyalty to its management);

exercise power over their own company’s pension fund trustees and their fund managers to take a non-activist corporate governance stance on other companies implicitly in return for similar reciprocal passivity;

have major powers of patronage also over most other fund managers seeking their pension fund business, who are frequently part of wider financial organisations wanting investment banking or insurance business; and

avoid allowing separate advice to non-executive directors on the merits of significant takeovers and mergers despite the frequent clash with shareholder interests.

All of these compromised entities, *without exception*, have prospered despite the increasingly obvious neglect of shareholders’ best longer-term interests. The effective removal of all these inappropriate powers is thus the litmus test for any worthwhile reform of shareholder capitalism.

Some of the six inappropriate powers are beginning to be addressed. In America in late July the widely revealed serious abuses have culminated in the first significant regulatory legislation since the decade following the 1929 great crash (such as that on accounting regulation and reform, and requiring CEOs to guarantee their financial statements). In Britain the investigation of reforms began earlier. To be actively contemplating or enacting major legislation represents a significant change in public policy for both countries the importance of which would be hard to overstate.

Proposed or contemplated reforms in the two countries primarily address auditor integrity and independence. The other five inappropriate powers are not widely appreciated.

Deeply entrenched short-termism

If corporate managements have major inappropriate powers, however, they also suffer from a major weakness which they share with fund managers. They suffer from a damaging restriction which handicaps their performance and damages the interests of shareholders. This is the market pressure to raise corporate performance as measured by share prices over unrealistically short periods of time, often over only 2-3 years. This pressure is manifested by the shortening average periods of tenure of CEOs of major companies and their immediate teams, now down to 4 years (and falling) in both America and Britain. This pressure, mainly from fund managers urged on by investment analysts, is itself the result of the increasingly shortening periods (typically 3 years in Britain and rather less in America) over which fund managers are judged. Perversely this is largely due to the terms imposed by pension funds controlled by corporate managements. Such periods are unsuitable for most industries. They prevent corporate managements and fund managers alike playing to their long-term strengths to the clear detriment of the much longer-term interests of most individual and all beneficial shareholders saving mainly for retirement – a particularly serious weakness. In this matter corporate managements have a fully justified and serious complaint. Effective reform must also resolve these perverse short-term pressures. CEO short-termism is powerfully reinforced by generous contractual termination payments and the fact that their share options usually vest if a merger or takeover bid occurs – see below.

We next set out more fully the serious, interdependent and damagingly reinforcing weaknesses which effective reforms must address.

Absentee ownership, the double deficit

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

It is a fundamental tenet of free market capitalism that the system rests on the effective ownership of private property, i.e. that owners choose how their assets are used to best advantage. It is thus particularly unsatisfactory that the largest single category of personal property, stocks and shares (including the beneficial interest in stocks and shares held collectively via investment institutions, mainly to provide retirement income) should lack effective ownership. Those who hold shares directly (50% of all shares in America, 20% in Britain) are individually so insignificant as to be virtually powerless. Those who own shares beneficially are if anything even more powerless. Only if shareholders can *combine* effectively – and in practice this applies only to institutional shareholders – will corporate managements be held accountable. It seldom happens save in a rare corporate crisis by when the damage has been done, as for instance Marconi and Enron.

The investment institutions

The only shareholder contenders who could hold corporate managements accountable, the investment institutions and their fund managers, are organised somewhat differently in the two countries. In America, the tradition of individual investment remains strong with half of all shares owned personally. Most of the rest are owned by life assurance companies, mutual funds and direct benefit (DB) pension funds whereby companies invest to provide staff with pensions. Under powerful tax incentives introduced in 1970 - the '401' (k) clause – employers are switching to direct contribution (DC) schemes. In Britain they pay their pension contributions directly to an employee's chosen unit trust (mutual fund) whereby the investment risk falls on the employees. An American employer's contribution can and frequently is paid in the form of its own shares such that many employees (as at Enron) held over 50% of their retirement funds in their own company's shares. In many mega companies, such as GE and Coca Cola, the proportion is 75%, and in Proctor & Gamble, over 90%. While a company is stable and growing this seems acceptable, but for employees' jobs and pensions to be alike tied to a rising share price is dangerously risky.

Increasingly, most of employee contributions to 401(k) schemes go into a wide spread of shares, and sometimes an employer's contribution also. Mutual fund firms compete heavily for this huge business. Their corporate governance activities (if any) will thus have a crucial effect on both the level of pensions and American corporate governance. There is to date no tradition of corporate pension fund or mutual fund corporate governance activity comparable to even the occasional activity of some British investment institutions. The sole occasional exceptions are some of the larger public sector pension funds which are in no way beholden to corporate managements. (An honourable example is the College Retirement Equity Fund – CREF) Thus, in America, opposition to very high executive remuneration or the routine repricing of share options is almost unknown, as is regular direct pressure on failing CEOs to resign. There is resentment but realistic recognition that shareholders lack the power to do much about it. American CEOs frequently lose their jobs because of short-term performance failure which investment institutions and fund managers require, but this is due to market pressures not shareholder activism. Whether the recent corporate scandals will cause lasting change remains to be seen.

British individual share ownership has always been much lower than in America. As a percentage of all shares it has fallen in 50 years from 50% to under 20%. Tax incentives for pension provision (half via individual policies held with life insurance companies) plus the benefits of professional fund management have greatly favoured collective shareholding. Hence, apart from individuals, British shares are held approximately 25% each by pension funds and life insurance companies, 10% by unit and investment trusts, with the remaining 20% held overseas, mainly by investment institutions. Increasingly corporate pension provision is being switched to much less generously funded DC schemes with most major companies closing their long-established DB schemes even to existing employees.

British investment institutions have been occasionally activist over the last decade or two but fall far short of being regularly activist on failing companies as last year's important reports by Paul Myners and the Company Law Review group attest. (The leadership of the British Telecommunications' Pension Fund and its manager Hermes provide a model forthe industry.) In part this stems from their small size relative to that of companies. British pension funds seldom hold more than 2%-3% of any large company and life insurance companies 3%-4% but only 2% or less in mega companies. In America the individual holdings in the top 500 companies are much lower, seldom exceeding 1%, and averaging ½% or less. The disparity of size and hence influence for *individual* investment institutions is thus small in both countries, particularly in

America. It is only the *latent collective* power of investment institutions which could give them real and continuous influence.

Corporate pension funds, controlled by their corporate managements have almost never been activist in either country. There is an implicit understanding that each company's pension fund will refrain from an activist stance in return for a reciprocal stance from all the others because corporate managements prefer to discourage any form of corporate governance intervention to their mutual benefit. As for life assurance companies, banks, mutual funds (unit trusts) and investment trusts, they are respectively in competition with their peers, and hence co-operative action is comparatively rare. Many are parts of wider groups also seeking banking or insurance business. Many own fund managers and so are additionally wary of antagonising corporate managements. There is an explicit duty on all these institutions to be pro-active investors on behalf of their beneficial shareholders - indeed it is trust law in both countries albeit seldom enforced. But that collective action which alone could be influential is rare, and largely confined to gross underperformance usually over many years, or after very serious corporate management misconduct by which time it is too late.

The fund managers

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

Investment terms are always agreed with clients but fund managers have the prime responsibility for choosing the strategy best suited to client needs. They unquestionably exercise great power in determining investment decisions. Their top managers and specialists are amongst the highest paid people in Britain and America, at least equal to most senior corporate managers. In Britain, the fund management of the major pension funds of the top 100 companies (over 75% of the stock market) is highly concentrated on the top ten fund managers. They thus compete fiercely to attract and retain major corporate business, inevitably reducing their scope for holding corporate managements accountable.

The inability of fund managers to hold corporate managements (their main direct or indirect paymasters) accountable inevitably causes them to seek risk diversification by holding very wide spread share portfolios, the reaction of a ‘punter’ rather than a ‘proprietor’. This process, as noted earlier, is compounded by the fact that their clients expect funds to perform well over only relatively short periods, 3 years in Britain and rather less in America where competition is even fiercer. This highlights one of the most significant weaknesses of shareholder capitalism, the serious mismatch between the periods over which fund managers are judged and the rather longer periods (say 5-6 years) which would better suit most beneficiaries. Client pressures thus inevitably cause fund managers to favour shares expected to perform well on a short-term basis, which has caused many commentators to blame fund managers for share bubbles and collapses over the last 2½ years.

There is a harmful and destructively intensifying process at work here whereby optimal long-term corporate performance is damaged, and with it the interests of most investors. Thus there are few incentives for either fund managers to take as long-term a view as their investment skills justify or corporate managers as their strategic management skills justify – yet fund managements blame corporate managements *collectively* for putting them under undesirable short-term pressures and vice versa! To break this vicious circle is one of the most important challenges for corporate governance reform.

Fund managers are divided into 'active' and 'passive'. Active funds go in for ever changing selective portfolios and asset allocations whereas passive ('tracker') funds – now managing 30% of all funds – hold all shares in an index and charge much less. As passive pension funds perform well in bull markets active funds have largely replicated their shareholdings (i.e. 'closet' indexing) because there is safety in overlapping portfolios. With most fund managers holding most shares most of the time they lack the incentives to try to improve companies almost entirely for their competitors' benefit.

The systemic fault

The analysis of the investment institutions and their fund managers reveals that, despite their huge latent collective ability to enforce corporate management accountability for their beneficiaries, they do not and cannot achieve it. The institutions are not to be blamed for not discharging these duties because there is a *systemic* fault which prevents them. The systemic fault is that shareholders, whether individual, institutional, or beneficial, all lack the necessary incentive and ability. The fact that all would benefit from the introduction of such full accountability and superior governance, however, in no way ensures this will come to pass. Unless the members of a group are few, or unless there is coercion or some other special device, they cannot and will not act to achieve their common or group interest. There needs to be a sufficient *individual* incentive for enough of the entities to act together to make the necessary effort and to bear the costs, even though, if successful, all the non-contributing members will benefit at no cost (i.e., overcoming the "free-rider" problem).[4] Crucially this type of problem cannot be resolved by market forces or, by definition, the problem would not exist, particularly when the potential collective benefits are so large (see below).

In the case of corporate governance, the position could hardly be less favourable to collective action. There is not just one large group that needs to act but several (individual shareholders, investment institutions, fund managers, and beneficial shareholders), each with little contact with most of the others, and in the case of the beneficial shareholders, none at all. It is this that explains why, despite the many worthy attempts at reform in the 1990s, little real change was effected in either America or Britain and why so much more remains to be done. The groups' inertias were impossible to overcome. A tiny handful of senior corporate managers in each country can and do prevail over that of the huge bodies of individual and beneficial shareholders. Effective action requires realistic, powerful incentives for effective countervailing power. We argue below that the necessary catalyst can only be modest but well targeted government action which can break the systemic fault and create a demand for free market forces to provide effective corporate ownership.

The hoped-for market forces in Anglo-American capitalism which are intended to hold corporate managements accountable to owners have broken down. The breakdown has occurred because of the failure of successive governments, (whether due to incapacity, unwillingness or, more probably, failure to recognise the serious problems arising from the huge rise of tax incentivised investment institutions) to enforce the basic law of trust as it relates to conflicts of interest. But it is nonetheless desirable, we would say essential, that ways are found to enable and require the trustees for the underlying beneficial owners, the investment institutions and their fund managers, to discharge theirresponsibilities. Successful corporate governance reform may require more than this, but it does not require less.

In both countries public sector pension funds are the most active fiduciaries having few conflicts of interest, but their staffs generally lack business experience. The more knowledgeable corporate fiduciaries who could bring business expertise to bear are – as noted – mainly passive. Hence institutional activism to date is easily derided as naïve and unsuitable. .

We understand and share the reservations expressed about more regulation, especially in the light of the excessive existing burden in both countries. But if the analysis of a systemic fault is accepted then change cannot occur without the involvement of an *external* catalyst as argued by Mancur Olsen. Senior managers are not going to propose reforms which reduce their present extensive powers. Investment institutions and fund managers want to hold on to their existing major clients, to attract new ones, and to avoid the reputation of a troublemaker with corporate managements. Any conscientious institutions would gain only a few per cent of any reward from holding a corporate management successfully to account, but 100% of the costs and the clear risk that they will probably lose business to their non-troublesome passive competitors. Hence, at present ***passivity pays***. Passive institutions gain 95% plus of any occasionally successful action at *no cost*, and a real chance of more business from the failures of activists. It is a no win situation for conscientious institutions and a no lose situation for passive ones. In these circumstances investment institutions do not and cannot achieve effective continuous accountability. This is the uncomfortable reality facing all who seek to improve corporate governance. (It explains why British institutions are fiercely resisting the essentially modest requirements for institutional activism in the 2001 Myners Report.) Proposed reforms must be judged against this reality which has been neglected by virtually all past and current major corporate governance investigations.

Board composition and accountability[5]

The reality

The traditional view of publicly quoted companies is that they are run primarily in shareholders' interests by senior managers with closely aligned interests under the control of independent non-executive directors. The truth is otherwise. Shareholders take no part in the nomination of directors. American shareholders have no powers of nomination, nor effectively do British individual shareholders. British investment institutions resolutely refuse any such role, despite the strong recommendation of the Cadbury Report. Therefore chairmen/CEOs nominate them since nobody else can or will become involved.

Nomination committees consisting primarily of non-executive directors increasingly recommend non-executive candidates. But the critical appointment and any renewal depends on

chairman/CEO agreement and is usually at their initiative, a process which falls far short of true independence. Non-executive directorships are generally prized, so how well can one hold one's benefactors to account? While current practice falls far short of original legal intention its supporters claim that it avoids the potential disharmony of non-collegial boards. However, non-executives cannot fulfil their clear external accountability responsibilities if disagreement with CEOs or even a board majority is considered disloyal. What credence can be placed on an 'independent' director under pressure not to act independently when required?

Shareholder responsibility for board nominations is very clear in Britain. It is the obligation to ensure the services of an appropriate board of directors on a continuing basis, an obligation which is routinely delegated to chairmen/CEOs. But shareholders retain a powerful reserve power. The Company's Act permits the removal of directors by shareholders at a specially convened 'Extraordinary General Meeting' (EGM). In America, while the obligation is the same, implementation is more difficult. Reforms now being discussed may permit the same simple activism mandate as in Britain.

The end result in both countries is then that there is only ever one set of nominations for directors who are nearly always unanimously elected. Institutional investors usually give their unanimous consent in advance in the form of proxy votes fairly described by Professor M.A. Eisenberg as "coerced ratification". The reality is thus of self-perpetuating boards without any ownership involvement. But chairmen/CEOs and their executive colleagues cannot fairly be blamed for a situation not of their making but due rather to legal restrictions in America and to apathy, acquiescence and the systemic fault in Britain. Hence the oft repeated dictum that shareholders "...appoint the directors" does not bear serious scrutiny.

The misconceptions

Careful analysis of what boards do or can do in a crisis is needed. British boards, with a non-executive chairman, and up to half of the board comprising senior executives are better informed than American boards where typically the CEO is the only executive member. Non-executives typically devote 10/15 days a year to board duties (sometimes more in Britain), which may not match their growing responsibilities. Boards seem to work adequately only when the demands are predictable and slender.

A window on the Enron board

Senator Carl Levin, as Chairman of the Permanent Subcommittee on Investigations, has recently provided perhaps the most authentic view into the nature of US boards at a hearing with the five most senior directors of recently bankrupt Enron. These individuals are the flower of America's director culture; they each had served for seventeen years; they chaired the most important committees – executive, finance, compensation and audit; three had earned doctorates; all were paid a minimum of $350,000 a year. They appeared voluntarily and at substantial personal inconvenience and legal hazard in order to articulate plainly and repeatedly that individually and

collectively as members of a board they were not responsible *in any way* for the collapse of Enron or for the loss of investments, pensions and jobs.

Chairman Levin issued a formal report in which he concluded that blame lay at the door of the board. Peter Drucker provides the context: "Whenever an institution malfunctions as consistently as board 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." (The same comment applies to investment institutions and fund managers. It is all part of the systemic fault referred to earlier.) Is the experience of the Enron directors confirming Peter Drucker's conclusion - you can count on the board except when it is really needed? If so, there are major policy implications.

Some characteristics of the Enron non-executives with hindsight suggests caution. The unusually high pay, an average of 17 years service and no board self-evaluation all suggest too little rigorous scrutiny of management. Without an independent chairman, an issue never raised, who was responsible for ensuring the board covered its full responsibilities? In evidence the non-executives felt they were widely mislead but had no direct personal responsibility. The accepted they were approving seriously incomplete financial statements. When management set up the 'independent' off balance sheet entity under the CFO and to which corporate assets and debts were 'sold', the non-executives could not accept that they had waived the corporation's conflict of interest rules since they had accepted the CEO's assurance that no harm would result.

The details revealed by the Enron hearings are essential to understand the often fragile defences to corporate excess and misbehaviour in American boards. Perhaps they are not able to discharge the responsibilities placed on them. If so, the investing public has been mightily mislead.

The Enron case provides unique insight. As we turn to the very different situation in the United Kingdom, one question obtrudes – what were the lessons from the Marconi Hearings? The losses, albeit absent fraud, were just as egregious as with Enron. Or what do we learn from the fact that there were no Marconi Hearings or Railtrack Hearings? Or any interest by regulators? Is it explained by the absence of any fraud? Or is it just a reflection of a more conformist culture?

In both countries we are seriously misled by the language describing corporate governance. Why do we say shareholders elect the directors and auditors – their two main monitors – when they take no part? Why do we ignore blatant conflicts of interest? Why do we pettifog so endlessly trying to refine definitions of 'independence' which everyone knows to be untrue? Huge and largely unaccountable powers have been relinquished to corporate managements contrary to the legal and democratic principles of both countries. We must acknowledge and redress it.

Alan Greenspan's simple remark in his March 2002 speech at the Stern School in New York City that American corporations are essentially characterized by "CEO dominance" not only shocked the conventional wisdom but it directly challenged the American insistence on – at least – a vocabulary of democratic institutions in describing corporate functioning. The whole subject of

corporate governance needs similar frankness if a system that lives up to the essentially sound principles of accountable shareholder capitalism is to be created.

In Britain the effectiveness and accountability of corporate boards – due in part to splitting the chairman and CEO roles - is considerably better than in America while still falling well short of what is desirable. The CEO, however, is still the dominant figure. Boardroom revolts are still very rare, and resignations of even a single director on a matter of principle almost as rare. Further, seldom is any public statement made – they just go quietly in the traditional British manner despite the Hampel Committee's call for a frank and public explanation.

In sum, the British system of corporate governance and the greater accountability of its corporate boards have something to teach America. But Britain still suffers from most of the serious weaknesses and conflicts of interest and shares the same necessity for major reforms. Therefore any British complacency would be quite unjustified.

Management remuneration abuse

Few subjects in shareholder capitalism attract more comment, most of it hostile

than the remuneration of CEOs and other executive directors. It is the 'smoking gun' of corporate governance failure in both countries. High remuneration is strongly defended as the necessary reward for risk taking and high performance on which growth, prosperity, jobs and pension benefits all depend – a natural and key part of highly successful, market-driven shareholder capitalism. From the mid-1980s remuneration has accelerated at many multiples of average earnings to levels unrecognisable to the preceding generation of highly successful executives. Pay is determined by remuneration committees, usually advised by the company's remuneration advisers appointed by the management who determinetheir fees. Such committees consist mainly of CEO appointed CEOs of other companies with a generic interest in a rising tide of 'acceptable' levels of reward. Investment institutions exercise almost no checks on behalf of their beneficiaries in America, and not many in Britain. For British remuneration (on average the highest in Europe but less than America) to be justified by an appeal to American levels, which result from a highly flawed remuneration determination process with no independent accountability, is highly suspect.

Executive remuneration, while high in both countries compared with rival nations or the past could be at least partly justified if it reflected very high sustained corporate performance, but this is very far from the general case. There are almost no reputable objective studies in either Britain or America which have found any significant correlation with corporate performance. This is due in large part to the pressures and incentives for short-term performance – see above. There is, however, a close correlation with the size of companies (see below). In judging managements' real performance, however, we would emphasise that in the 12 years share boom to early 2000, share prices rose 3 times faster than earnings as shares were significantly re-rated, a rating which is now unwinding.

In both countries since 1983 stock options have been by far the largest remuneration component, massively larger than before. They are a poor form of incentive – a risk-free one-way bet. They

correlate poorly with corporate performance and if share prices fall are usually re-issued at a much lower price. Option costs have not been shown in published accounts yet in America now account for an average of 12% of issued shares. After the abuses of this year it is likely options will be costed in future with the FASB and IASB leading the way and major US corporations changing voluntarily.

Many top American companies would be trading at a loss if stock options were properly costed. Reliable estimates of adjusted earnings range from 9% to 20% lower and up to 70%! in IT companies. A recent Federal Reserve study estimated large companies' annual earnings to have been overstated by 2½% during 1995-2000, and reported profits would have peaked in 1997, three years earlier than reported. These are major information distortions and almost certainly fuelled the stock market bubble and serious misallocation of resources, particularly to high tech firms. Wall Street was silent. All this puts into perspective the now embarrassing self-serving actions of the Business Round Table ("BRT"), an organization comprised uniquely of CEOs, when the Financial Accounting Standards Board ("FASB") tried to require the value of stock options be charged against earnings. Using its members' huge political power, the BRT forced an overwhelming vote the United States Senate to direct the FASB to back down. FASB, with no independent basis of support, had no choice but to comply. At the Levin Hearings in July 2002, Republican Senator Peter Fitzgerald specified that this act was uniquely causative of the losses in corporate value that are now afflicting so many beneficiaries and shareholders in the United States.

Market forces were damaged by these actions but investment institutions and analysts were silent. It is inglorious story, far removed from free market discipline. The British story is little better but matters less as options comprise only 2%-3% of issued shares.

Transparency is insufficient for reform

Britain has its own patchy record of openness over directors' remuneration. The 1995 Greenbury Committee wanted to show the full but hitherto hidden and often very high costs of corporate pension fund contributions to directors' remuneration. Business and management organisations, fearing a 'fat cat' backlash, opposed disclosure fiercely and forced a compromise. Companies could choose between partial disclosure of relevant facts and full disclosure. Fears of adverse publicity or pressures to be less generous were quite unfounded, however, because the investment institutions and their fund managers showed no interest either way in how companies reported. All chose to avoid offending the senior managers of either clients or potential clients. Little will change until institutions are required to protect their beneficiaries' interests. Information transparency alone will not overcome neutralised corporate governance structures.

Examples of excess

No instance typifies the 'kidnapping of corporate value' by top officers during takeover more dramatically than the failed effort by WorldCom to acquire Sprint in 1999. The Sprint option plan was to be triggered by any change of control, an almost universal condition in option agreements. Shortly before the announcement of the acquisition, which the entire financial community realized would fail on antitrust grounds, the Sprint board changed the definition of 'change of control'. Henceforth such a change would be deemed to occur upon a shareholder vote to approve a sale or merger *even if that sale or merger never took place.* This was done

during negotiations with WorldCom and without public disclosure. The acquisition as was foreseen failed but the options then vested. $1.2bn was extracted by Sprint executives. Many of the vested executives left the company immediately and business continued – exactly as before the 'transactions' (this matter is being litigated so we will use neutral vocabulary to characterize it) except for the loss of money and personnel. This must be the nadir of correlation between executive compensation and shareholder value.

History will look back on the last decade of executive compensation in the United States as an atrocity. It is important to consider the parameters of excess where pay far exceeded any historical precedent despite lack of any correlation with corporate performance and hence investor interests. Options increased sixfold in the 1990s, 75% going to the top 5 executives – the rest split between lesser executives with little if any for most employees

The remuneration excesses went beyond mere numbers. Consider for example what the board of International Business Machine company did for its retiring CEO, Louis Gerstner. (What follows is a bare summary of two important illustrative cases, first for an American CEO and then a British one. Full details are given in our website paper.) Gerstner has been chosen because his case represents 'best' practice for an undoubtedly outstanding CEO. After a very successful, well rewarded (hundreds of millions of dollars) ten year career at IBM he was given $15m of restricted stock as a leaving present, a 10 year consultancy with no specific duties or commitments, 20 years of access of IBM aircraft, offices, apartments, medical insurance, free tax and estate planning and free financial advice. In this last gift IBM is paying for its former CEO to manage his other assets, a compensation completely removed from shareholders' interests. Just how much should a CEO be paid when employed to pay his own expenses after retirement?

Similar arrangements were made in numerous other American mega companies - for example for Jack Welch on retiring from General Electric last year[6] - and on a reduced but still very lavish scale for CEOs of lesser companies.[7] Finally, failed CEOs and senior managers in both countries are routinely rewarded generously when dismissed. Such practices, which encourage CEOs to take corporate risks while being well protected from any adverse outcome, are further evidence of divergence with investor interests and the clearest possible indication of governance failure.

No discussion of controversial British executive remuneration practices could exclude brief mention of the remuneration of Sir Chris Gent, CEO of Vodafone, the world's largest mobile telephone company. No-one could dispute that so demanding a role in a world ranking company should be highly and appropriately rewarded and deserves a high salary in what is a difficult, turbulent and volatile industry requiring strategic judgment of a high order. But one can legitimately dispute the scale and type of incentives on top of salary. The cardinal indisputable principle for Vodafone and all other companies is that incentives should align closely with shareholder interests, i.e. to longer-term performance. There should be no additional rewards unless and until that criterion is met. It has not been met over the last 3 years in Vodafone.

Controversy began in early 2001 when Gent was paid a £10m cash transaction' bonus for winning a fierce takeover battle against the leading German company, Mannesmann which made Vodafone Britain's largest company. It was fiercely denounced by all the serious press as it was not tied to whether the transaction would be successful. It was subsequently modified to half cash and half deferred shares. With the subsequent decline of Vodafone shares by *circa* 75% only £1.5m of shares were finally paid this July. Having also paid £13.4bn for third generation (3G) mobile phone licences Vodafone has remained the target of sustained criticism in each of its last 3 meetings with shareholders. In addition to the huge fall in share prices Vodafone has been forced to write down assets to record a £13.5bn loss, the largest in British history. In this year's summer meeting the CEO was re-issued generous share options at the current price (now 75% less than the Mannesmann takeover). Institutional criticism was muted after extensive consultations and some performance hurdles. Only one fund manager voted against. The main newspapers remain resolutely critical.

The Vodafone story sheds some interesting light on the current state of Anglo-American shareholder capitalism. First, no mega company need fear an institutional shareholder revolt unless the company is close to failure. Automatic supportive proxy votes will see the directors through. The institutions have too much to lose from sustained protests. Second, the senior corporate managements will respond to whatever incentives they are given (and have anyway negotiated). They could of course honorably refuse excess rewards when shareholders suffer severely, but few do.

Third, and crucially, the main performance incentives are flawed. Where the remuneration trigger is 'earnings' it is frequently earnings before interest, tax and amortization (EBITA), a false measure which ignores major costs. It has thus encouraged many debt-financed takeovers not in shareholder interests. But neither conventional pre-tax earnings nor share values are satisfactory performance triggers because critically both ignore the amount of capital required to generate growth. This inescapably encourages CEOs to concentrate on growth. The right criterion, that urged by the Stern Stewart consulting firm and others, is to calculate what changes have occurred in a company's 'economic value added'. This takes earnings after deducting the company's cost of capital. The Stern Stewart figures for Vodafone[8] showed positive results for 1997-99, but for the last 3 years the results have been dire, negative EVA of £2.5bn, £12,0bn and £9.6bn respectively. The need is for fully independent remuneration committees advised by remuneration consultants of their own choice, with no connection to the company's management and who have EVA expertise. This approach is far removed from that of virtually all major British and American companies all of whom can claim to be applying conventional best practice. When the overall system is flawed 'best practice' comparisons have no place.

Finally, it should by now be clear that the widely canvassed reform of putting CEO remuneration to a shareholder vote will not work until remuneration committees are fully independent and both expertly and independently advised.

Too many poor value mergers and takeovers

The efficient use of resources is a main pillar of capitalism. In fully efficient capital markets, *with strong corporate governance to protect shareholder interests*, and with wise guardianship of the public interest (for instance avoidance of monopolies) no generally valid criticism of mergers and takeovers can be sustained. The inescapable losses would be accepted as the short-term price for the general long-term benefits resulting. Such changes are inevitable when companies decline in efficiency, fail to satisfy customers or when stronger competitors emerge.

Two criticisms, however, are well founded, first when takeovers or mergers benefit senior managements but not shareholders – the majority of deals, see below – and second when only a third party hostile bid can succeed in changing anunderperforming management. Effective corporate governance could overcome both weaknesses. Innumerable Anglo-American studies over the last 25 years reveal that 60% plus (many put the figure even higher) of such deals actually destroy shareholder value, with shareholders in acquiring firms suffering the most (the 'winners' curse'). The CEO incentives for short-term increases in share values (discussed earlier) drive this process. It is also driven by two other powerful forces, the understandable desire of fund managers to boost their own figures, and the huge fees earned by investment bankers (and other corporate advisers). Such incentives are perverse in view of the poor record of success. A February 2002 Survey by KPMG Consulting[9] of the largest international takeovers consummated at the height of the bull market show that a third are now being unwound.

Businesses acquired at great cost are being disposed of for fractions of their acquisition costs. Since that report was compiled the evidence has become even stronger. The firms where the greatest, indeed almost total loss of shareholder value has occurred were serial acquirers of other companies – for instance Enron, Tyco WorldCom - whose high stock market ratings required continuousacquisitions. This ultimately unsustainable process was supported by compliant boards and often shady accounting practices which are now leading to numerous prosecutions. Understandably global mergers and takeover activity has slumped to the decade's lowest level.

Two investment banking reforms are long overdue. First the huge banking fees and related bonuses need to switch from being entirely transaction based to include some significant measure tied to the longer-term success of such deals. Second – as is beginning to happen in America – bank investment analysts must be entirely divorced from corporate finance business. It should be a matter of major concern to investment banks that they have grown rich by these two serious conflicts of interest while helping to destroy so much shareholder value.

Auditors, consultants etc. too close to management

The relationships between corporate managements and auditors, remuneration consultants and investment bankers are frequently unsatisfactory.

General audit considerations

The accepted right of shareholders to elect auditors is usually a mere formality. The management nominates the auditors, nearly always to reappoint the incumbent and routinely this is unanimously approved. And as the largest auditors have become predominantly consultants, with consulting fees on average three times audit fees, there is a further major conflict of interest between these incompatible activities.

The major abuses have occurred in America, but the position is not satisfactory inBritain. Accounting is an art as much as a science. There is always some flexibility in agreeing costs, earnings, assets and liabilities. CEOs are under strong pressures to maximise earnings and minimize liabilities in their term of office. Auditors appointed and paid by managements are subject to inappropriate pressures which are often difficult to resist, particularly with high consulting fees also at risk. Too many American auditors succumbed. British auditors are not immune from similar undesirable pressures as the British Chairman of Ernst & Young acknowledged when considering widespread collective failure. [10] We fully and gladly acknowledge there have been no major accounting frauds in Britain. That said, share prices have fallen almost identically with America indicating similar investment concerns or British prices should have held up better.

Audits are performed primarily for shareholders to provide an independent check on management stewardship. They are equally critical for all other external users of accounts – lenders, creditors, investment analysts, and rating agencies. Consultancy services help managements to run companies better. Auditors owe external loyalty, consultants internal. The same firm cannot combine both roles and enjoy the full trust and confidence of the different parties involved, a logic which the global accounting firms are accepting in America. Global market pressures may well result in a similar outcome in Britain.

John Biggs, the highly respected CEO of CREF, testified before the Senate on 27 February on the relationship of companies and auditors. It is particularly noteworthy that his principal

recommendation, that companies should periodically rotate their auditors, was dropped out of the much applauded Sarbanes / Oxley Bill which became law at the end of July.

Many American managements and their auditors have behaved disgracefully in the last ten years. The failure to cost stock options – see above – contributed heavily to the corporate failures that have followed by giving CEOs a misconceived incentive to pursue growth regardless of shareholders' longer-term interests. The approach was all part of an emerging trend in financial services, the desire to get rich by helping CEOs achieve their personal aims. Auditors, particularly the largest began to offer major consultancy services, a high growth activity compared with staid auditing. They pushed the flawed EBITA definition of gross earnings already discussed rather than the properly conservative net earnings, and *pro forma* accounts which relegated many costs and liabilities to footnotes. The top managements of some American companies, supported by their auditors, were thus issuing financial statements ***that they knew*** were without economic significance. These ended in seriously misleading accounts in too many American mega companies, and often in their total failure. The damage to stock markets from many years of 'constructed' earnings is an as yet unquantified contingent liability.

Auditing remedies

The only remedy which can restore the full auditor integrity on which all financial markets depend is to split auditing from *any* potentially compromising consultancy work for the same client. (There will be no loss of accounting and consultancy work, it will merely be rearranged between firms.) The audit committee should comprise truly independent non-executive directors who alone should recommend auditors to shareholders, and also their fees, with the authority to agree any additional fees for the adequate investigation of anomalies, distorted accounts, and suspected fraud.

It is argued by accounting firms that such reforms will add significantly to costs with the implication that they are unnecessary. This is both true and irrelevant. There is no justification for misleading audited accounts to save money. The damage to shareholders has been huge, quite dwarfing any cost economies. Further, it is not for either corporate managements or auditors to determine the appropriate costs for shareholder protection, that is for shareholders and independent audit committees. The large accounting firms should accept with good grace the major reforms now shown to be fully necessary for the protection of shareholders, creditors, and indeed all users of accounts. It represents the best contribution they could make to restore full public trust in the accounting profession which is anyway its most precious possession.

Remuneration consultants

Precisely the same logic should apply to senior executive remuneration consultants. They too look to managements as their paymasters and thus dominant clients, as they usually advise on managerial remuneration and incentives on a company-wide basis. There is a clear conflict of interest if they also advise the remuneration committee on executive directors' remuneration and incentives. The conflict of interest is as obvious as the remedy. Remuneration committees, comprised solely of fully independent non-executive directors, should be independently advised by consultants of their own choice. Again, in aggregate, there would be no loss of business to the consultants, merely a rearrangement of clients. Such independent consultants will need to master EVA techniques – see above. It will no longer suffice to rely mainly on comparative remuneration analysis with other similar firms. Their whole approach needs changing radically to incentives which enhance investors' long-term interests.

The need for relationship investment bankers

The last point concerns the appointment of investment bankers to advise corporate boards on takeovers or mergers. It is of course entirely appropriate that corporate managements should choose the most appropriate banker to advise *management* on these matters which usually comprise some of the most critical decisions facing any company. Given, however, the fact that 60% plus of mergers and takeovers actually destroy shareholder value but can greatly enhance management remuneration there is *routinely* a clear conflict of interest. Hence, when a management wants to mount a bid, defend against one or propose a merger, it should need to make its case to the independent directors given the huge sums at stake, the large disruption of management and employee time and jobs, the conflicts of interest for both management and their advisers, and the very high failure rate. (Mindless growth via takeovers has been a prime cause of shareholder value destruction and frequently failure in numerous mega companies.)
 Independent directors need independent advice, and thus long-term relationship advisers free of conflicts of interest. Such advisers should not have any other relationship with the company they are advising, but should only be used to evaluate objectively the advice of others. They would need and deserve a large annual retainer fee. Such arrangements are always employed when executive directors seek to buy out their whole company (a whole firm MBO) and have an obviously impossible conflict of interest. Accordingly, the non-executive directors negotiate on behalf of all shareholders and retain independent financial and legal advisers. The same principle should apply to significant bids and merger proposals of managements, and to their proposed takeover defences. The conflicts of interest are just as great as in management buyouts.

Dangers from the sole criterion of maximising shareholder value

Maximising shareholder value has long been accepted as the guiding principle of shareholder capitalism. But until 15 years ago it was not regarded as the sole criterion either by corporate managements or anyone else. It was accepted that corporations existed to serve the interests of society and derived their legitimacy from that object. Given that the earnings of shareholders, corporate profits, are the residual outcome after satisfying customers, paying all costs including those of employees, and obeying society's laws and implicit obligations, it was long held that profits could be maximised only by meeting the legitimate interests of all these wider groups. Corporations could not exist at all without their willing co-operation. This time tested concept was abandoned in favour of the view that companies existed overwhelmingly to maximise a narrow conception of shareholder value. All incentives to managements, fund managers, and investment analysts reflected this single criterion. The shareholder value was no longer the accepted definition of long-term net earnings – reflecting underlying investor requirements – but distortingly flattered earnings ('EBITA' – see above) over increasingly shorter periods. CEOs not achieving substantial growth of at least several multiples of annual GDP growth were widely regarded as failures. Hence CEOs embarked on savage cost cuts, large staff lay-offs, selling off non-core businesses and major programs of takeovers and mergers. Customer service standards frequently declined, suppliers were pressured to perform much better for much less, and employee loyalties and morale suffered. Research and development, staff training and welfare, pensions, etc were often cut back. Share buy backs to drive up prices and increase the value of share options became widespread. Some of the process undoubtedly achieved needed greater efficiency but much was destructive from any longer term perspective.

The process was frequently carried to excess, as was convincingly set out in a well researched recent American book by Allan Kennedy,[11] He set out a cogent analysis and warning of the dangerous consequences of the single-minded pursuit of short-term shareholder maximisation for the sole benefit of corporate managements and investors. While applauding sustainable productivity improvements he demonstrated that short-term maximisation mortgaged many firms'

futures, a prophecy amply fulfilled in the 3 years since he published. As he foresaw, a major backlash was emerging from all the many disadvantaged parties who are now organising to defend their interests. Kennedy particularly blames over-powerful, large company CEOs pursuing short-term earnings to maximise their share options. He presciently foresaw the formidable challenge to successor CEOs of failed or damaged mega companies to regain long-term investor backing, restore employee morale, secure stakeholder co-operation and overcome political disquiet.

The clear need is to refocus CEOs and their senior colleagues to *circa* 5 year incentives geared to sustainable performance. Maximising shareholder value then reverts to being an acceptable criterion because it necessarily embraces the legitimate interests of all the other parties whose long-term co-operation is vital to corporate success.

The need to realign interests with shareholders

The most compelling conclusion from all the above analysis is the need to re-align the interests of CEOs and their senior colleagues with the longer-term interests of individual and beneficial shareholders. All the other main parties involved – non-executives, auditors, investment institutions and fund managements – like corporate managements - have grown rich over the last decade or so despite the fact that they have frequently failed to serve shareholders' best long-term interests. This is not because they are corrupt, but rather that all of them are beholden to their paymasters, corporate managements, as the price of being in business, the *systemic fault*. They were unable simultaneously to look after the longer-term interests of the shareholders, independent and beneficial shareholders alike. And sadly ***they forgot that it mattered.*** Under the comfort of the greatest share price boom in post-war history they comforted themselves that shareholders were also growing significantly richer by the year. This justified the quite unprecedented extremely high rewards to CEOs and their senior management colleagues, and of course to all of themselves. There was little realisation that these rewards for all concerned, and particularly CEOs, were so far above any long-term trend as to be unsustainable. Instead, economic growth at these stratospheric levels was held to be sustainable because of 'the new paradigm'. Analysts could even talk without being ridiculed of the Dow Jones rising to well over 36,000 in a few years, and the FTSE 100 to equivalent levels. But in the end reality obtains. The brutal events of this year have shown unmistakeably that complacency and the neglect of basic duties is no longer acceptable.

The CEOs of mega companies became a race of superheroes. Inevitably, and rather more in America, CEOs began to believe this propaganda. Aware that most traditional checks and balances had been neutralised they assumed even greater powers over their corporations which for their tenure became their creations. (They equally overwhelmed politicians, accounting bodies and regulators.) If they did not deliver double digit earnings growth and an even higher growth in their share price, the market would ditch many of then. By then, with huge cashed in stock options and generous compensation payments, they did not care. Many went on to repeat the process at another company. Any alignment of corporate direction with shareholder interests was coincidental and fleeting.

The clearest evidence is the already mentioned experience with options. Eventually the Federal Reserve and, then, the Securities and Exchange Commission approved the "cashless" exercise of options. First, shareholders would dutifully authorize the issuance of large numbers of shares on the boards' specified conditions, ignoring danger warnings by proxy voting companies. The option plans, overwhelmingly for CEOs, were adopted. Rapidly rising share prices made executives anxious to exercise their options to lock in profits. Then the machine went into high gear. Top executives were able to exercise their options *without putting up any money – a*

‘cashless exercise’ or free loan. Their companies usually had a general repurchase stock program, with the shares sold ‘off market’ to avoid any adverse price impact. We are told Ken Lay, Enron’s CEO, ‘borrowed’ money from the company every day for several weeks, repaid by proffering shares back to the company and these ‘sales’ only had to be made public at the year end. Finally, the machine had provision for its eternal life. A proportion of the option shares were converted into new options at current market value (called ‘reloading’) which in a rising market guaranteed endless wealth without any reference to corresponding benefits to the company or its shareholders.

All this now makes grim reading in the light of the huge falls in share prices in America, and mirrored in Britain, and the wave of major American corporate failures resulting from corporate misbehaviour not infrequently accompanied by fraud.

Britain equally needs corporate governance reform

[This subsection for British version only]

Britain, with its superior accounting system and the almost universal split of the roles of Chairman and CEO, has largely escaped the worst excesses of American corporate scandals and fraud. This has led many spokesmen for British directors and accountants to assert, often smugly, that such conduct ‘could not happen here’. The claim is made that after the accounting reforms in the early 1990s, and a decade of major corporate governance reports resulting in a combined code of conduct consolidated under stock exchange listing rules, there is little more to be done. Accordingly the British Government is warned not to undertake ‘knee jerk’ reactions to what is essentially an ‘American’ malaise. While it is quite true that Britain has fared better than America in this matter such reasoning is seriously mistaken. As we have repeatedly argued, criminal conduct is only the excess result of a more generally unsatisfactory corporate governance system with the at least six inappropriate powers of CEOs, all of which exist equally in Britain. The checks and balances to make managements accountable are equally weak in both countries. Both suffer from the same highly damaging pressures for short-termism on CEOs and fund managers alike. Both have too few independent non-executives. Both have failed to link management remuneration to corporate performance,[12] and have made stock options the main management incentive. Both have failed to control mega companies. Both have the same high proportion of poor value takeovers and mergers. In both countries auditor independence is endangered by inappropriately large consultancy fees, and in Britain as well as America it is admitted that audit fees have frequently been used as loss leaders to secure or protect consultancy assignments (audit fees are consequently now rising significantly in both countries). In both countries investment institutions and their fund managers have been equally neutralised by the systemic fault. Equally the evidence for the increased value of well governed companies and the small cost of achieving it are the same in both countries. And so we argue strongly that effective corporate governance requires the same reforms in both countries.

In sum, while Britain has suffered little fraud *the overwhelming proportion of the massive and widespread loss of shareholder value in America as well as Britain is due to unchecked corporate management excess, not criminal action* of which there has been relatively little. And, as well argued by Dan Roberts[13] from an investors’ or employees’ perspective: ‘it can often make little difference whether the company is brought down by incompetence or greed’. Both have the same roots of ‘insufficient checks and balances’. Finally, if America has suffered from much more corporate excess than in Britain it needs to be remembered that most of it has come to light from an exemplary number of continuing, prompt and thorough investigations. The Federal Government and its Agencies, the Senate and Congress, and several State Governments have

all been active, leading to court hearings with many more pending. There have been no comparable specific British corporate investigations into major losses of shareholder value (e.g. in telecommunications) and we ought to ask 'why?'. No-one can be sure of what would emerge from such investigations.

We conclude that there should be no room for complacency in Britain by any of the parties involved. Business and financial lenders, investment institutions, accounting institutions, investment banks, the CBI and the Institute of Directors should all be asking what each can best contribute to restoring public and investor confidence in business integrity. The British Government – as seems likely – should remain as concerned as the American Government to achieve major reforms and the consequential significant gains. That alone will keep Britain internationally competitive with America.

The weaknesses in perspective

We have identified and analyzed a considerable number of serious weaknesses in contemporary Anglo-American shareholder capitalism, and there may well be others. But what is apparent is that not only are these weaknesses individually serious, they are also interdependent and damagingly progressive. The prime weakness underpinning all the others is undoubtedly the absence of effective, committed, knowledgeable long-term owners. Until that is effectively addressed none of the other weaknesses admit of satisfactory remedy. What is needed is to identify achievable satisfactory remedies which are benignly reinforcing. Before taking a brief look at the best of the Anglo-American remedies proposed by others, and then setting out our own comprehensive proposals for effective reform, we consider the evidence that superior corporate governance is worth the effort to achieve it. The evidence is in fact strong that there are substantial, achievable and cost effective gains for all involved.

WELL GOVERNED COMPANIES ARE WORTH MUCH MORE

Until this year many, perhaps even most managements have regarded governance as at best a fad and at worst a time-consuming nuisance, distracting management from its main task of achieving shareholder value. There are, however, four sources of persuasive evidence that well governed companies are both less risky and worth more, sometimes very much more to their shareholders and everyone else associated with them. One findingstands out. Companies where directors invest a significant sum *fromtheir personal resources and have to hold the shares for appropriately long periods* outperform the others. As Jack Welch put it: 'stock ownership changes behaviour'.

We begin with the incontestable evidence of the last year or so that the absence of good corporate governance can lead to large losses of value.

Avoidable massive value destruction

The last 24 months has seen one of the greatest debacles of shareholder value destruction since World War II. It occurred mainly in the high-tech industries. First were the 'Dot.Coms' most of which lost over 90% of their peak trading values, with the rest going bust. Next, with losses ten times as large, were the telecommunications companies, probably the largest asset bubble in history with $1 trillion (£670 billion) of debts worldwide. Many of the worst accounting practices were in this industry. The most prominent British case has been the former British GEC, renamed 'Marconi'. Not allowing for some significant asset distributions it fell by over 99% from its peak market value of 18 months ago, but no accounting deception was involved.

The most spectacular corporate failure, however, with the most far-reaching consequences in either country, has been the fall of Enron, once America's seventh largest company, from over $70bn in late 2000 to bankruptcy a year later. Similar and in some cases larger falls in value have emerged in WorldCom, Tyco, and Global Crossing, all of which had questionable accounts. When such companies began their spectacular growth in profits and share prices few critical voices were heard. Shareholder protection was largely absent. We do not argue share values would not have risen markedly nor that significant falls would have been averted had such companies enjoyed excellent governance. But with powerful and effective owners plus fully independent and diligent non-executive directors, the rise in share values would not have been as great, there would have been far fewer poor value mergers and acquisitions, and far greater financial transparency. Most of the companies concerned would have survived albeit at lower values, and investors been better off.

The non-executives of such failed companies have been widely criticised. They exercised few sceptical checks on CEOs and the failure seemed to surprise them as much as everyone else. But as many commentators have noted, numerous other parties – including auditors, institutional investors, fund managers and investment banks - must also share the blame for strongly supporting corporate action to raise short-term share price rises which proved to be unsustainable. Conventionally good corporate governance has largely failed to hold senior managements accountable to shareholder interests. The negative evidence – that poor corporate governance contributes significantly to the destruction of shareholder value (and to blight many others in the process) – is indisputable.

Reducing avoidable corporate waste

There are two significant forms of waste in inadequately governed companies, both touched on earlier. First there is no perceptible link between the remuneration of senior managements and sustainable corporate performance. Investors support very high remuneration for proven long-term performers such as Warren Buffett at Berkshire-Hathaway (BH) and Jack Welch at General Electric. They enjoyed the security of being able to achieve exceptional long-term returns and usually excellent shorter-term performance also. Relatively few senior managers enjoy such patient support to demonstrate their real capabilities. The remedy – well supported by studies - is both longer tenure (with suitable safeguards) suited to the constraints of particular industries, and *payment largely in shares which must be held for say 5 years even if dismissal occurs earlier*.

The second main source of avoidable waste is linked closely to the first one. 60% plus of mergers and takeovers destroy shareholder value but enhance senior management rewards which correlate closely with size rather than performance.

The twin approaches of longer-term, genuinely performance-related pay, and the avoidance of conflicts of interest in mergers and acquisitions would overcome much of the present avoidable waste which so damages investors.

Benefits of committed ownership

Few Institutional investors try to be long-term *owners* (as opposed to long-term investors), i.e. to take a direct and strong proprietorial interest in the companies in which they invest. Instead they invest in a very wide spread, constantly adjusted portfolio of shares. (Overall share turnover is high, frequently 1-2 years in America and 3-4 in Britain.) They aim to optimise their portfolio's risk/return balance, and have relatively little contact with individual managements (compared with companies with committed long-term owners) save in a rare crisis. Hence their achieved returns have a relatively narrow spread since their portfolios are similar to their competitors.

In contrast, a minority of highly selective investors achieve significantly higher returns with concentrated portfolios of say 10-20 shares. (Many experts consider these provide a sufficient spread of risk if well chosen.) Such concentrated portfolios allow investors to know their companies and management well, to have a sufficiently large holding for influence, and because long-term ownership is the aim, often a seat on the board. Warren Buffett through BH is the most celebrated and successful exponent of this strategy. BH takes large committed positions in a dozen companies whose business they understand and expect to perform well long term. Buffett usually becomes a director and is highly welcomed by managers and other shareholders. BH's shares usually trade at a premium to the underlying holdings, a rare distinction. Further, and crucially, Buffet negotiates favourable terms for his investment and expert board participation. Typically it is a convertible preference share on favourable conversion terms if the stock appreciates significantly, and with his involvement, it usually does.

The BH approach illustrates two critical governance points. First, the long-term commitment and portfolio concentration permit deep knowledge of a company and its strategy usually leading to returns well in excess of widely spread portfolios in the long term, and usually in the shorter term as well. (BH avoided the dot.com/high-tech/telecommunication fashionable mania and the subsequent massive falls.) Second shareholders welcome board membership to secure the benefits of superior long-term performance and stability from active, knowledgeable, committed, long-term owners.

Two of the most compelling American examples of the value of effective shareholder involvement in governance are the saving of Salomon Brothers by BH and the extraordinary resurrection of Waste Management Company under the leadership of Ralph Whitworth of Relational Investors.

Positive evidence

The case that well governed companies are worth more is additionally supported by positive evidence. There is a growing body of international studies providing strong evidence that superior governance can both significantly increase corporate value, and substantially reduce the risk of corporate failure.

A 1999 study of nearly 400 companies in 27 countries found that the better investors were protected the higher the value they would put on assets.[14] A major shareholder exercising power responsibly on behalf of all investors raised share values, and a narrow, selfish shareholder reduced them.

Impressive supporting evidence also comes from a series of major studies undertaken by McKinsey over 7 years from the mid-1990s. The latest and most comprehensive study by McKinsey's London office was conducted with many major institutional investors.[15]   The survey in April/May 2002 was conducted in 31 major countries in 5 continents with the Global Corporate Governance Forum. It covered 200 major investors who with their parent organisations had $9trillion under management. The survey showed that 70%/80% of investors would pay a premium for a well governed company defined as follows:

a majority of outside directors, truly independent, i.e. no ties with management;

directors with significant shareholdings;

a material proportion of stock-related pay;

formal director valuation in place;

a very responsive attitude to investor information requests on governance issues.

The survey shows that governance remains a great concern for institutional investors worldwide, one on a par with financial indicators when evaluating investment decisions. An overwhelming majority will pay a significant premium for good governance, 14% in America and Western Europe, 12% in Britain, and rather more elsewhere where governance standards are less well developed. These premiums are down on a similar survey of two years ago (18% then for Britain and America) but in view of the flood of American corporate scandals in the few months following the survey the American premium would be higher today. The much higher recent falls in the share prices of companies with complicated financial structures is further evidence of the worth of good governance.

McKinsey acknowledge that while it remains difficult to measure the market price impact of the premiums that investors say they will pay for well governed companies, there is little doubt that good governance does feed through and is a powerful argument for effective reforms. It is much strengthened by the widespread acceptance that corporate governance is a priority for major improvement in both countries. Without it confidence in equity investments will remain fragile. Major government sponsored enquiries are under way in both countries and America has recently passed the Sarbannes-Oxley legislation. Clearly superior governance in both America and Britain has risen in importance since the McKinsey survey.

The survey also finds strong evidence that institutional investors want better accounting disclosure, the costing of stock options (80% support), more independent boards, better director selection, proper board evaluation procedures, and a greater time commitment from non-

executives. Most importantly, those surveyed support the need for more government involvement and better regulation is generally acknowledged.

In sum, the numerous recent major studies now show widespread business and political support for effective corporate governance reform in both countries given the clear benefits to all concerned. Significantly larger benefits still would flow from the highest standards of corporate governance including knowledgeable, committed long-term owners, the subject of our own proposals below. The surveys show convincingly that a majority of investors now consider governance issues on a par with financial issues, a finding strongly supported by non-executive directors. Quantification of the gains from good governance show that the reduction of risks and the potential rewards are high against the modest costs involved and are anyway essential to restore public and investor confidence and the damaged reputation of so many people and companies.

We next consider very briefly the previously proposed remedies of the most significant entities in America and Britain before setting out our own comprehensive proposals.

Previously proposed third party remedies

On so important a topic as corporate governance there have been many major British reports in the last decade but few American ones. Only the crisis of the last six months has increased the pace of major investigations, with America leading the way. (A much fuller examination of these investigations is given in our website paper. What follows is only the briefest summary as background for policymakers.) Despite the many changes recommended in earlier years their overall impact, with but few exceptions, has been relatively small. The major weaknesses identified above, particularly absentee ownership, largely persist. The reason is that the underlying premise of the investigation was that companies were run in the interests of shareholders who had sole responsibility for putting any shortcomings right. The effective neutralisation of shareholder powers, the excessive powers of corporate management, and the general failures of the main checks and balances went largely unrecognised.

The main British initiatives

The 1992 Cadbury Report was the first, best and most influential. It put corporate governance firmly on the business agenda. It recommended the general desirability of separating the chairman and CEO roles, the importance of effective non-executive directors, the forming of board committees (audit, remuneration and nomination) mainly of non-executives, the rotation of audit partners, and generally encouraged investment institutions to take an interest in board appointments. The acceptance of splitting the top two roles and tougher accounting standards saved Britain from the type of scandals now evident in America – a remarkable achievement.

The 1995 Greenbury Report addressed public and government concerns over executive remuneration. It was a sound and hard-hitting report covering the most pertinent points but its effect on the inexorable rise on remuneration was negligible. It insisted on transparency in the high cost of senior management pensions but the revealed costs were largely ignored by the investment institutions. Transparency alone, without fundamental reforms, is quite insufficient.

The 1998 Hampel report saw its role as primarily consolidatory because it believed that '… public companies are now amongst the most accountable organisations in society'. It recognised few conflicts of interest and felt that shareholders had sufficient power for any needed reforms. Thus all the British reports contained good sense but ignored the problems of effective implementation.

More progress was made in the extensive Government sponsored Company Law Review of 2001. It recognised that the role of investment institutions was a matter of major public interest and that they should be active and responsible in the exercise of shareholder power. It also accepted the need for better regulation.

The other major report was the Myners Report on institutional investment, also in 2001. It recognised that corporate managements should be held properly accountable to shareholders and that investment institutions should be prepared to look after beneficiaries interests despite conflicts of interest. Its remedies ignored the impossible nature of the conflicts of interest involved. But the Government has rightly accepted the general thrust of its recommendations as do we.

The main American initiatives

The main American initiatives are entirely a product of the last six months when the President, the Congress, the Justice Department, and the SEC have conducted major reviews and insisted on major reforms. These largely take the form of tougher criminal penalties for securities fraud, establishing a powerful accounting oversight board, restricting the consultancy services of auditors, and requiring CEOs and CFOs to certify financial statements. It is by no means the end but rather the beginning of American corporate governance reform. Its good intentions are not in doubt but they do not comprehend the neutralisation of all the parties expected to provide corporate checks and balances, the corroding effect of short-term pressures on CEOs and fund managers alike and the general systemic weakness. But American public trust in the integrity of American business has been so shaken that more reforms are inevitable, and it is to aid this process that this paper is put forward for both countries.

COMPREHENSIVE PROPOSALS FOR EFFECTIVE REFORM

A four point reform programme

It has long been observed that no-one looks after other people's assets as well as they do their own. The need is to move from the rhetoric of giving primacy to longer-term shareholder value to making it a reality in a socially acceptable way commanding public trust. This requires the alignment of the interests of corporate managements and institutional intermediaries, to those of individual and beneficial shareholders. The present widespread and serious conflicts of interest would never be tolerated in politics. They should no longer be tolerated in business where most of the retirement savings of America and Britain are subject to significant avoidable risk and damage. Indeed such is the current public and political mood in both countries that major

changes are inevitable. The challenge is to ensure that the changes realistically address the main problems.

The existing law governing trustees and fiduciaries in America and Britain already explicitly requires that they act solely in the interests of their beneficiaries for the exclusive purpose of providing them with benefits. But this law has not been enforced in either country, nor have there been penalties for inaction. What is required is not so much new law as the enforcement of the existing law on pension fund trustees, life insurance company fiduciaries (in fact on their boards of directors) and, by implication, equally on the boards of mutual funds, unit and investment trusts. Our clear preference is to enable owners to look after their own interests by removing the handicaps which presently prevent them. As we have shown, it is impossible for either owners, or their intermediaries, or self-regulation, or market forces to overcome the present serious systemic fault. An effective external catalyst is needed and that catalyst can only be government.

Every credible analyst of the desirable scope of government action - from Adam Smith and John Locke to Frederick Hayek and Milton Friedman - agrees that government must set standards and secure compliance to encourage action for the public good and discourage actions for public harm. Government involvement is now clearly needed in corporate governance to guarantee the nations' citizens the neglected rights of ownership of their major assets, stocks and shares. Prominent business leaders such as Hank Paulson of Goldman Sachs and Sandy Weill of Citicorp have spoken eloquently to the same effect. To this end we believe four modest but highly catalytic government actions are first necessary. What is needed is a clear and consistently enforced public policy. It must give all owners' representatives, the intermediary investment institutions and their fund managers, the clear fiduciary requirement to be active with respect to companies held in their portfolio accounts, and the confidence that they will not be placed at a competitive or reputational disadvantage with their competitors by complying. Above all else, it must be unmistakable that both governments intend and are capable of enforcing the trustee and fiduciary laws for the "sole" purpose and "exclusive" benefit of their beneficiaries' interests - the greater part of the funded pensions of most citizens - in an even-handed way.

The four comprehensive proposals are as follows:

> 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 that this policy is applied by all executive and judicial branch agencies, competition 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

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. (Such Wall Street figures as the financier and former Ambassador Felix Rohaytn and the much respected governance counsellor Ira Millsten, have recently suggested that direct nomination of at least a single director should be considered.)

Crucial Interdependence of the Proposals

All four proposals are both necessary and mutually reinforcing. They would create a ***market*** demand for effective ownership and governance.

The general statement of government support for an effective shareholder presence is more than justified by the evidence that well-governed companies are both less risky and worth much more to shareholders and all other involved parties. Government endorsement is also necessary to create public trust, to ensure that all parties understand public policy, and to guarantee that all organs of government, will support the policy. With equities held directly and indirectly comprising the largest category of personal assets by far, nothing less than effective accountability should be acceptable to the main political parties of both countries.

The requirement for all trustees and fiduciaries is equally critical. While it can fairly be argued that this is already the law, it is almost universally neglected *without penalties*., It needs to be given specific, continuous and strong public emphasis and credible uniform enforcement to overcome present inertia and conflicts of interest - i.e. to make all trustees, and fiduciaries, proactive in the sole and exclusive interest of their beneficiaries. Effective corporate governance cannot be a spectator sport.

Without being compelled to vote institutions, largely and understandably paralysed by their present major conflicts of interest, might well not face up to the costs and risks of active engagement with corporate managements. Unless all are required to act too many are likely to take the soft option which would undermine the whole reform process. To be compelled to vote without the requirement to do so solely and exclusively in the interests of beneficiaries would also be likely, given the inescapably continuing conflicts of interest (dependence on corporate management patronage), to result in institutions taking the line of least resistance. There would be, as at present, an almost automatic vote in support of nearly all corporate management proposals regardless of merit. It would thus give the spurious appearance of democratic accountability while leaving the reality of the double accountability deficit intact.

The fourth requirement of requiring shareholders to nominate at least three non-executive directors is absolutely crucial to get indisputably independent accountability into the heart of every public company boardroom. The appointment of a quota of a few shareholder nominated non-executive directors would still leave chairmen/CEOs and their colleagues to appoint the rest. As with non-executives now, the great majority of such independent shareholder directors should be chosen from the same pool of experienced businessmen and professionals as they are drawn from at present. Indeed, they would be unlikely to attract sufficient support from either individual or institutional shareholders if they were drawn from any other source. The crucial difference would be that the shareholder

nominated directors would be quite free of *any* implied obligations. The record of all too many failed and damaged companies has shown that the appointment of independent non-executive directors - endorsed by *all* Anglo-American enquiries, commentators and the financial press - is far too important a matter to be left solely to executive directors who have conflicts of interest, and many of whom have abused the position. Nor would such shareholder nominated directors be a divisive presence. They would be concerned to show their colleagues that they also were primarily committed to the sustainable success of their company. The management appointed non-executives would be equally concerned to demonstrate that they too were independent in their conduct and judgments. We believe that this is one of the most necessary and overdue of all corporate governance reforms because it ensures, ***for the first time,*** that shareholders can participate effectively in the choice of a critical mass of truly independent non-executive directors. This is widely but falsely claimed to be the present reality by nearly all official enquiries and corporate managements. (It is routinely asserted that the majority of management appointed non-executive directors in both countries are 'independent'. This has not prevented the many evident corporate shortcomings and failures.) All that our proposal amounts to is making a partial reality of what is presently but wrongly claimed to be the universal position, namely '…that shareholders elect the directors.'

Immediate benefits from implementation

This paper has focused on the key corporate functions where "real governance" is essential if accountability is to be effective. There are numerous ways in which the necessary changes could be effected through a combination of compulsory shareholder action and the strengthening of regulation and company law. Substantial new commitment of time, energy and resources is contemplated for shareholders. These requirements should not be viewed as an additional burden, but rather as a restoration of the highly cost effective ownership function to its original conception. Nobody ever passed a law providing that ownership would be devoid of responsibility. No determination was ever made that ownership should cease. Its dilution was unintentional, a by-product of other priorities.

In no respect do we suggest intrusion on the essential limited liability of those who hold equity securities. Individual shareholders neither have nor should have any legal obligation to be activist. We, however, are addressing the specific present situation in which controlling equity shares are held in trust. We are strongly urging that the law of trusts be applied with respect to this asset and that the trustees be required to inform themselves and to take whatever action is necessary in order to preserve and enhance the value of portfolio companies.

So long as owners were flesh and blood human beings with at least substantial minority holdings their own self-interest could be counted on to provide appropriate surveillance over corporate conduct. As the unintended consequence of successive tax-incentivised retirement policies, ownership was transferred from human beings to legal constructs – to pension and other trustees. These creatures of law had no concept of 'self interest' on their beneficiaries' behalf. Thus the critical balance of human monitoring has gradually disappeared from the governance of the modern publicly held corporation. Our suggestions would restore the traditional equilibrium by specifying and enabling shareholder responsibility in specific areas.

At present, as set out earlier, chairmen/CEOs and their executive director (senior management) colleagues have six major inappropriate powers giving rise to serious conflicts of interest at the very heart of the Anglo-American shareholder capitalism malaise. The proposed reforms would remove them from all chairmen/CEOs.

i. They would no longer choose all of their ‘independent’ non-executive colleagues – a minimum of three would be required to be nominated exclusively by shareholders.

ii. They would no longer choose the auditors – it would be the responsibility of the fully independent non-executive directors’ audit committee to recommend the auditors to the shareholders, probably on rotation, and the auditors could perform no other service to the company. The audit committee would have an adequate budget, including provision for any special investigations it deemed necessary. (This reform which we have long advocated is now becoming public policy in America and will probably be required in Britain.)

iii. They would no longer appoint the remuneration consultants to the non-executive remuneration committee – rather the committee would choose their own independent consultants who could perform no other service to the company.

iv. They would no longer have the power to neutralise the corporate governance responsibilities of their pension fund trustees – the trustees would be bound to exercise their full legal responsibilities of working solely for their beneficiaries in their exclusive interest on all the companies in which the pension fund held shares.

v. They would lose the effective patronage over their pension fund’s fund managers (and hence over other fund managers seeking their company’s business) since whichever managers were chosen would be legally required to work solely and exclusively for that pension fund’s beneficiaries.

vi. They would have to allow the non-executive directors independent legal and financial advice on all significant mergers and takeovers, and accept that the non-executives would have an obligation to advise shareholders directly. Not to do so would be to flout the long established legal requirement to act in shareholders interests in a matter on which there are often major conflicts between the interests of shareholders and managements, It is in this area that there has been the greatest single loss of shareholder value.

The removal of the six inappropriate powers that have gradually been acquired over many decades would leave corporate managements free to concentrate on their prime responsibility of achieving sustainable longer-term performance for all individual and beneficial shareholders for which they should be appropriately and generously incentivised (see below).

Effecting change

There are a number of necessary supporting actions to make sure the four main

interdependent proposals are fully effective in providing workable solutions to the six major inappropriate powers of corporate managements, and to overcome the damaging short-term restrictions placed on managements and fund managers.

i. After decades of neglect in enforcing existing trust and fiduciary law there needs to be a committed regulator (perhaps the Financial Services Authority in Britain and the SEC in America) to ensure that the law will henceforth be enforced. It is inherently paradoxical that intermediaries should be tightly regulated as to their honesty and competence in dealing with their investments but under no practical obligation to ensure that valuable shareholder rights in the companies in which they invest are actively, efficiently and continuously discharged, solely and exclusively on behalf of the beneficiaries

ii. The fund management contracts of pension fund trustees and other fiduciaries should normally be for a longer sensible fixed period of say 5 years (subject to safeguards) to encourage fund managers to take longer-term views, to adopt a wider variety of investment strategies and to play to their long-term strengths. This would clearly be in investors' interests.

iii. It is equally desirable that directors should increase the expected tenure of CEOs, subject to appropriate safeguards, for longer than the present 3 to 4 years (or less). CEOs and their senior management teams could then develop longer-term policies where appropriate, and play to their own presently neglected longer-term strengths. The provision of longer tenures for both fund managers and CEOs is both essential and mutually reinforcing, indeed one cannot sensibly have one without the other.

iv. Independently advised non-executive remuneration committees will need to give CEOs and their senior management colleagues generous incentives for longer-term corporate performance. Over and above a generous salary to reflect responsibilities there should be a significant annual grant of restricted shares (*not* options) realisable only when some appropriate economic value added (EVA) benchmark is passed. Most of such shares should not be realisable for an appropriate period (say 5 years) which matches the longer-term interests of most underlying investors.

v. Finally, non-executive directors should be paid substantially more since they would have greater responsibilities and would need to devote more time to the job.

Such supporting actions are needed to make a reality of the four recommendedproposals. They would become possible indeed likely with universally pro-active investors and some shareholder chosen non-executive directors.

Possible market responses

The implementation of the four recommended catalytic actions of government would require investment institutions and their fund managers to provide *or procure* active knowledgeable committed long-term ownership on behalf of their beneficiaries. (Because many conflicts of interest with corporate managements would still exist the majority of institutions would probably choose to procure the discharge of their ownership responsibilities by sub-contracting them to disinterested investment intermediaries). What follows is a brief summary of what is given on our website, and a much fuller analysis in our recent books.[16]

The introduction of effective corporate governance would generate a market demand for new skills and services as investment institutions and their fund managers would have to discharge the new obligations. (The systemic fault presently prevents the emergence of any market demand for such services hence the necessity for the four recommended, modest catalytic government actions. Once an economic demand existed for such services market forces can be relied upon to meet them efficiently.) How the institutions and their fund managers would respond would be a matter for individual decisions and the effect of market forces in the changed legal circumstances. While it is not possible to predict the outcomes in detail, it is useful to outline some possible likely reactions to the changed governance requirements.

It is important to appreciate that the new obligations would not directly overcome the present conflict of interests. Fund managers, life insurance companies, mutual funds, investment and unit trusts, will still want to retain corporate clients and attract new ones. As the new obligations are inescapable, however, they will either have to discharge them directly, or delegate them to new investment intermediaries who do not have their conflicts of interest. (An interesting precedent was set by Barclay's Chief Executive Officer Patricia Dunn. As a director of Hewlett Packard, she resolved the recent conflict of interest with respect to voting Barclay's shares by delegating responsibility to Institutional Shareholder Services, a special purpose proxy firm.) Some of the large insurance companies, some of the large public sector pension funds and the relatively few activist investors will take the former route as they do now. But they will have to do it continuously and across their whole portfolios. The majority of institutions will prefer the latter route. To meet the new demand we foresee the emergence of *inter alia* 'special purpose trust companies' (SPTCs) and probably also 'specialist investors' (Sis) and 'relationship investors' (RIs).

SPTCs

The purpose of an SPTC would be to meet the new compulsory obligation to vote the shares in the portfolios of its clients. These clients would be the great majority of investment institutions who would prefer to delegate their voting responsibilities into disinterested competent hands rather than be subject to conflicts of interest between their beneficiaries and corporate managements. They would represent a *competitive market solution* to the new and inescapable corporate governance requirements. Their appointment, fees, and indeed their very existence, would depend on offering a valued commercial service for the new governance obligations in full competition with other providers.

Sis and RIs

The emergence of SPTCs in combination with the new corporate governance legal obligations and a regulator could well ensure sufficient accountability by both corporate managements and investment institutions such that no further market developments would be needed. But other new investment intermediaries could emerge if SPTCs were not sufficiently effective with very large companies, or because of additional benefits they could offer. Two other forms of intermediaries might emerge, 'specialist investors' and 'relationship investors'. Both would be based on the benefits from small concentrated specialist investment portfolios holding shares for the longer term and seeking board representation (like Warren Buffett's Berkshire-Hathaway company previously described,) They would own a sufficient shareholding for long-term investment in a small portfolio of companies and would seek to discharge an ownership role. Unlike SPTCs, they would put up candidates to be shareholder directors for their fellow institutions to vote on.

"Specialist Investors" (SIs) would in effect be specialist investment trusts aiming to hold 4%-5% shareholdings in perhaps only 8-10 companies, enough for influence but not dominance. They would charge fees with a major performance based incentive. They would have small but experienced staffs made up of successful business executives and investment analysts. Their function would be to select a small portfolio of companies for long-term investment and to act as supportive and knowledgeable long-term owners, discharging the full corporate governance duties which would then be mandatory. This is broadly the strategy of Ralph Whitworth's Relational Investors whose successful preservation of value for WMX constituents was described earlier.

"Relationship Investors" (RIs) would be similar to SIs but more suited to the requirement of fund managers who would be the ideal candidates to organise them as an additional service. Their purpose would be to pool all or at lest most of the core shareholdings in the larger companies of a number of fund managers. These pooled but still minority shareholdings would have far more power and influence to be effective as a minority shareholder syndicate than the separate funds. Further, and crucially, their core shareholdings could be held for the long term despite any turnover in fund manager clients or portfolios. Like Sis they would seek say 3% to 5% holdings in major companies, enough for influence not dominance. They would discharge all governance duties on their holdings, and could put up non-executive director candidates. They too would represent a competitive market solution for the discharge of effective governance. Hermes Focus Asset Management has organised funds in the UK, Europe and the US which provide guidance for effective value adding in this mode.

Market forces in the new governance environment might well throw up additional or superior intermediaries, for that is what markets are good at once the demand for governance services is created. But one way or another effective new entities would compete to ensure that companies were fully responsive to long-term shareholder needs.

CONCLUSIONS

Anglo-American shareholder capitalism is prevented from delivering its optimum performance by strongly entrenched and destructively reinforcing weaknesses and short-term restrictions on corporate managements and fund managers. Together they comprisea major systemic fault. It is the unintended and unforeseen consequence of the decline in influential shareholders who aligned the longer -term interests of owners and managers, and their replacement by essentially passive institutional shareholders lacking the means and incentives to hold corporate managements accountable. Power has gradually been relinquished to such managements who have inevitably used it in no small part for their own gain. They have usually concentrated on much shorter-term gains for themselves often at investors' expense. Further, corporate managements have gained undue and undesirable power over auditors, investment institutions, and fund managers. The governance system is riddled with serious endemic conflicts of interests which would not be tolerated in other walks of life. A decade of major investigations and reports in the 1990s has produced mainly apparent rather than real governance. The resultant checks and balances introduced fail far too often. They are usually in evidence only after a company and its shareholders are severely damaged as in Marconi and Enron.

Savers around the world all seek a mode of investment through which they can earn the highest return at acceptable risk. Common stock of publicly traded companies provides investors with a particularly attractive blend of reward and risk, ***but only so long as they feel that the market is honest.*** Corporate governance is about providing this assurance. Only if investors are convinced first that they are making decisions to buy based on reliable information, and second that management is running the enterprise for their benefit, will the market place value stocks attractively. Many studies in both countries have demonstrated that equity investment normally outperforms all other categories of investment over the longer term. Hence, for 40 years equities have been the main investment of choice for all forms of retirement both by individuals and, far more importantly, by investment institutions on behalf of their beneficial investors. Most retirement incomes above basic minimal state pension take this form. The bulk of the beneficial shareholders are employees saving for retirement. With the rising costs and investment risk of pension provision passing increasingly to employees, and the expected fall of equity returns from the high levels of the last two decades it should no longer be politically acceptable to tolerate the largely passive absentee ownership practices of pension fund trustees, institutional investors and their fund managers. This is particularly so when the potential gains from companies subject to real governance are, as shown, so significant and would dwarf the extra costs involved.

At present there are almost no competitive market forces involved in delivering real governance despite the significant potential gains. Market power is not absent but takes the form of seeking short-term performance because the assured tenure of institutional shareholders, particularly their all important fund managers, is itself short term. The institutions, like individual shareholders, have become traders of shares rather than owners of companies. The critical value-creating ownership role goes by default. What is needed is to free all the main parties – corporate managements, investment institutions and fund managers – to play to their undoubted longer-term strengths and to be well incentivised to do so. It should no longer be possible for any of these entities to prosper unless they serve shareholders well. Accordingly, that should be the guiding principle for all reforms.

Investors, individual and institutional alike, have always looked to boards of directors, particularly the non-executive directors, to safeguard their interests. The record shows that far too many of them, all chosen by incumbent managements, have been inadequate protectors. The eminent Federal Reserve Chairman, Alan Greenspan, scathingly dismissed the conventional wisdom that so called 'independent' directors could or would ensure acceptable corporate governance. Britain, with the general split of roles between chairmen and CEOs has a better board system than America but still a far from adequate one. In America, however, there is no presently meaningful concept of a board independent of CEO power unless and until there is a damaging and often fatal crisis. The July 2002 Senate Hearings of Carl Levin are the more remarkable in making utterly clear the need for a Board Chairman separate from the CEO, yet the issue was neither addressed nor discussed by any of the parties, or in the Committee Report. In both countries, boards cannot continue to be based on the 'lie' that shareholders are meaningfully involved in the process of their selection. Some form of effective owner participation in selecting non-executive directors is an inescapable requirement.

Corporations are ultimately a system of power. Such is their crowning glory, and their potential either to enhance or to menace a free society. The principal concern of governance must be how to minimize the adverse consequences of the abuse of this power. Governance is about creating a framework within which a skilful management can create value. Governance does not create value; but it is vital to help assure a structure that both promotes it and prevents the needless destruction of value so much of which is now evident.

In this survey of Anglo-American shareholder capitalism we have argued that shareholders need a fully working system of effective property rights. The direct and beneficial ownership of shares

is by far the largest class of personal assets. Most shareholders are not able to exercise their rights directly. Their representatives, however, need to be fully incentivised to provide an effective countervailing power to hold corporate management accountable to shareholder interests for demonstrable major gains. As de Tocqueville observed, 'The vote is worth little without the institutions to make it continuously effective'.

It will be said that institutional investors do not want to be actively involved as owners of publicly traded companies, and that they are presently not trained or staffed to fulfil the needed functions. But once the law of trust which governs the fiduciaries is enforced, plus the other three complementary reforms put forward, these objections fall away. There would then be a strong market demand for the critical services via effective and well rewarded investment intermediaries which all beneficial investors need for their protection and prosperity. And if there is one thing we can be sure of about capitalism it is that market demands will be efficiently and competitively met. The practical problems of a system presently based on excessive corporate management power compels the conclusion that Capitalism without informed, motivated and effective owners will not long survive.

[This paragraph for British version only.]

We have set out a comprehensive set of integrated proposals for achieving such effective owners. What is proposed is neither more nor less than Margaret Thatcher's government achieved for trade union reform which was an essential part of Britain's 1980s economic recovery. It effectively returned the rights of trade unions to the members by means of secret ballots and thus made the unions accountable solely to their members' interests. The members of companies, the shareholders, deserve the same reform. It would deliver the same huge benefits to members and nation alike. Anglo-American shareholder capitalism could thus have the brightest of futures.

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[1] "The Legitimacy of the Business Corporation in the Law of the UnitedStates", 1780-1970, *University of Virginia Press,* 1970, p.89

[2] 'A survey of capitalism – punters or proprietors', *The Economist,* 5 May 1990

[3] (i) 'The need for informed change in the boardroom' by Bob Feltons and Mark Watson, 2002, and (ii) 'Global Investor Opinion survey: Key Findings' by Paul Coombes and Mark Watson, July 2002 – see www.mckinsey.com/governance.

[4] 'Mancur Olsen, *The Logic of Collective Action',* Harvard University Press, 1965 and 1971.

[5] On so important a subject readers are encouraged to consult the more extended analysis in our website paper.

[6] (i) 'GE shareholders fund Welch's life of luxury', *The Times,* 7 September 2002

[7] Executive Pay-Offs – Money for nothing?', *The Economist,* 18 August 2001.

[8] See Philip Coggan's column in *The Financial Times,*4 June 2002

[9] “Boom takeovers unwinding, says survey” *Financial Times,* 22 February 2002

[10] Nick Land, ‘Collective failure and the debacle at Enron’, *Times,* 28 February 002.

[11] Allan Kennedy, *The End of Shareholder Value,* Perseus Publishing, America and Orion Business Books, London, 2000

[12] Recent past and existing CEOs of Glaxo SmithKline, Granada, Marconi, Logica, Vodafone, BT and Cable & Wireless amongst others, have all been strongly criticised in the serious press for giving poor value for money for shareholders.

[13] Dan Roberts, ‘The Creeping Complacency’, *Financial Times* – 19 August 2002.

[14] R LaPorta, F Lopez-de-Silanes, A Schliefer and R Vishny, “Investor protection and corporate value”, NBER Working Paper 7403. See also “Protection money”, *The Economist*, 11 December 1999.

[15] Paul Coombes and Mark Watson, Global Investor Opinion Survey Key Findings – July 2002, *McKinsey & Company* at www.mckinsey.com/governance

[16] See in particular the Epilogue in Reference A, and Chapter 8 in Reference B.