CORPORATE GOVERNANCE AND PENSION PLANS

If One Cannot Sell, One Must Care

Positioning Pensions for the Year 2000

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> Thus the large funds are beginning to learn what Georg Siemens, founder of Deutsche Bank and inventor of the hausbank system said a hundred years ago when he was criticized for spending so much of his and the bank's time on a troubled client company: ***If one can't sell, one must care.***[i]

Introduction

Institutional investors, especially pension funds, are the largest holders of equity securities. This paper discusses what their role should be in the governance of the companies in which they invest. In the past, their involvement has been indirect, through the buying and selling of shares. But now their very size makes it almost impossible for them to beat the market -- they are the market. More and more, they are "indexed" -- invested in the market as a whole, rather than a selected group of portfolio companies.

In light of the evidence about the "value" of shareholder activism, this "permanent holder" status gives them additional opportunities -- and additional obligations as fiduciaries obligated to act "for the exclusive benefit" of the beneficial holders. This is best effected by evaluating ownership options with the same focus and risk-benefit analysis traditionally used in making buy-sell decisions. As a matter of law, ability, and policy, they cannot become involved in "ordinary business," but they can improve corporate value by encouraging governance structures that promote accountability, and therefore responsiveness to the market and competitiveness. This paper discusses a number of possible models for shareholder involvement in governance.

Pension Funds in the United States

Size Pension Funds make up 48.1 percent of institutional capital in the United States and 29.6 percent of the total outstanding equity.[ii] The pension system as a whole owns such a large percentage of the total equity capital of the country that "selling" its holdings is no longer a feasible method for dealing with underperforming companies.

As of the end of the third quarter 1994, the pension systems aggregated $4.6 trillion of assets of which $1.18 trillion were public funds, $2.51 trillion were private trusteed funds and the balance were managed as insurance assets. 43.8 percent of the assets of private plans and 48.7 percent of the assets of public ones were invested in equity.[iii]

Institutional Investors owned 51.5 percent of the total outstanding equity and 55.8 percent of the equity of the 1000 largest UNITED STATES corporations at year end 1993.[iv] By mid 1994 the five largest institutional investors owned 11.2 percent of the largest 25 companies.

Defined Contribution and Defined Benefit

There are two categories of pension plans with regard to benefits. The first, with a rapidly shrinking plurality (45.3 percent of assets) is the “defined benefit” plan. In these plans, the employer is committed to a specific payout, no matter what level of contribution is made by the employee and no matter what the performance of the investments. The employer, whether corporate or government, bears the risks; to an extent, the employer is guarantor of a specific defined benefit. In defined contribution plans (42.4 percent of assets), on the other hand, the employee bears all the risks. 40.1 percent and 32.1 percent of plan assets are respectively invested in equities by defined benefit and defined contribution plans.

In the case of both types of pension plan there is an incentive to achieve superior investment results. The plan sponsor of a defined benefit plan, whether public or private, clearly wants to reduce its obligation to make additional payments into the pension scheme. Defined contribution beneficiaries are entitled to those assets comprising their plan assets so the incentive to maximize values is personal and direct.

Obviously, everybody cannot achieve “superior” results. This has resulted in an increasing percentage of plan assets either advertantly or de facto being invested in “index” funds that match the market’s performance. Some have argued that the exercise of ownership rights, including voting proxies, becomes less important in an indexed fund, because there is no commitment to hold the stock. If the company is managed badly, the stock will fall, and the index formula will require that it be sold -- a self-activating variation on the Wall Street rule which says that investment managers should vote with management or sell the stock. Others have argued that as a matter of economics, index fund managers cannot compete by taking an active interest in voting the shares. The costs of evaluating each proxy issue will outweigh the return to investors, because index fund managers who do not vote will become free riders, benefiting at no cost to themselves from the work done by those who exercise the ownership rights. Those who do not incur the costs of exercising ownership rights will be more competitive by charging lower fees because they do not provide the additional service of active proxy review, while the returns are the same.

On the contrary, a fiduciary whose trading choices are self-activating must avail itself of every other mechanism, whether through the proxy system or a shareholders' derivative suit, to protect the assets that it manages for others. In fact, index fund managers have an obligation to monitor and analyze proxy issues that is even greater than that for managers of other funds. Indexed funds provide no discretion for asset managers with regard to trading. Index fund managers do not have the option of selling the stock if they do not agree with management's proposals; they have to wait until it sinks far enough to fall off of the index. Studies have shown that the adoption of devices that entrench management depress share value. Therefore, asset fund managers acting as fiduciaries must vote against their adoption and for shareholder proposals to rescind them, to ensure the maximum return to shareholders, the pension beneficiaries. The same goes for votes on issues like executive compensation and director election. Their fiduciary obligation may even be to initiate shareholder proposals. Certainly, a fiduciary cannot stand by and allow a firm in which it holds shares to siphon off corporate assets with no return in value to beneficiaries, just because the mechanism used is the proxy vote rather than cash.

But, indexed or not, institutional shareholders can act against their interest when they are presented with options that benefit each of them marginally, while harming the group as a whole significantly. They will accept the economic harm, because under the current proxy system,

shareholders do not work together to maximize the return to all of them. It is thus clear that shareholders, by working together, can work to the benefit of all of them, and it is clear that by failing to do so, it will work to the detriment of all of them. Fiduciaries are obligated to act, actively and diligently, in the interests of those whose trust they hold. They are obligated to be on notice of others similarly situated, and, by common action, lower their costs. As the institutions become larger, the free rider problem diminishes. Furthermore, If this obligation is clearly understood, either through a regulatory or judicial interpretation of the fiduciary standards or adoption of industry requirements by an organization like the Council of Institutional Investors, there will be no free rider problem. Institutional investors, both indexed and managed, can work together to hold corporate management accountable to make sure that corporate management gives shareholders, the plan beneficiaries, the highest return.

Public and private plans have many similarities but certain important differences. For purposes of this paper, the one important difference lies in the tendency of plan sponsors to dominate administration of private plans while public plans are more apt to function in a political mode.

The Role of the Government

The commitment of the state (or its subdivisions) to pay a “defined benefit” is in most cases guaranteed by the state constitution. Whether or not there are adequate funds in the pension trusts, the state is obligated to make the promised payments. Funding of pension systems is essentially a matter of inter-generational fairness. Public defined benefit plans are designed with the intention (though not always the reality) that the generation that receives the benefit of services pays the taxes to provide the pensions related to those services. Therefore, decisions about the appropriate investment policy for pension assets are essentially political because in the final analysis the electorate should decide on the levels of risk and reward thought appropriate for one time period or another.

The commitment of corporations to pay defined benefits is ultimately guaranteed by the federal Pension Benefit Guarantee Corporation (PBGC). But, in the first instance, it is promised and collateralized by the assets of the “plan sponsor” employer corporation. A medley of considerations underlie the investment policy of private companies: on the one hand, they can pursue high risk policies (in the manner of the airlines and steel companies in the 1980s) knowing that the PBGC will ultimately “bail” out the beneficiaries, or they can pursue the “conservative” path of assuring that their actuarial returns are achieved and the corporation has the highest assurance that it will not have to divert more than the planned payments into the system. Lawyers and courts can and will argue which alternative more closely achieves the statutory mandate that all trust assets be managed “for the exclusive benefit” of plan participants.

Investment Horizons

In general, plan sponsors, both public and private, benefit from maximum long term growth in pension assets. Also, plan participants benefit to the extent that funding of their benefits requires decreased commitments from employers or taxpayers.

A common stock-based investment policy for pension funds raises two separate problems. (I) There are drawbacks to public ownership of private enterprise. Pension fund holdings of common stock are viewed as “back door socialism.” This is especially problematic when it leads to politically-based initiatives from public pension funds that are unrelated to (or even contradictory to) economic returns. Some examples have included South Africa divestment and bailing out insolvent city governments. (II) Active management -- market timing, industry choice, stock selection -- has not been able, over time, to produce consistently better results than those of the market itself.[v] The level and profitability of fees to managers, consultants, trustees,

custodians and all manner of service providers to the pension industry is so high that it wipes out any advantage of active management and creates conflicts of interest that make it virtually impossible to receive unbiased advice about investment alternatives. The "indexation" of equity holdings is therefore as a policy and an investment matter compelling for public plans[vi] and competitive for private ones.

Public funds are entirely funded by the taxpayers and private plans, significantly subsidized through tax incentives, are thus funded by the taxpayer as well. Since it is the taxpayer who is at risk, It is not only appropriate but essential for government to assure that the funds are administered consistent with the public interest. This particularly includes the responsibilities of pension fund trustees as owners of portfolio companies.

Pension Plan Fiduciaries in the United States

Public plans are administered subject to the laws of the sponsoring state. Private plans are regulated by the Pension and Welfare Benefit Administration ("PWBA") of the UNITED STATES Department of Labor ("DOL") under the Employees' Retirement Income Security Act of 1974 ("ERISA").

Trustees of public plans are either appointed by a designated political official or they are elected by a particular constituency of plan participants; trustees of private plans under ERISA are appointed by the plan sponsor. In both cases, pension funds are administered by trustees who are subject to the highest standard of care developed by our legal system, the fiduciary standard. The fiduciaries of public and private pension plans have an unenviable role. By law and tradition they cannot personally benefit from favorable consequences through incentive payments and bonuses (with some exceptions), but they can be held liable for unfavorable ones by being fired, if they are in-house, losing the account, if they are outside, and even being prosecuted, if there is an allegation that fiduciary duty has been violated.

ERISA requires fiduciaries to consider only the interests of plan participants in their decision making. And this is their interest as pension plan participants, not their interest as employees or members of the community. But this provision has not been administratively enforced or judicially defined with sufficient conviction to mitigate the crippling conflict of interest problem that hobbles trustee behavior. Fiduciaries under ERISA are subject to strong industry pressures in the performance of their duties. It is clear to individual and institutional trustees that their continued employment is in the discretion of the plan sponsor. To the extent that they exercise their discretion in a manner that is perceived as inimical by plan sponsors, they can be sure of not being reappointed and of being "blacklisted" for new business by other employers.

The trustees of public plans do not need to fear commercial reprisal, but they are subject to political pressures.[vii] Although, on occasion, public plans such as CalPERS have been willing to oppose the managements of local corporations including Occidental Petroleum and Lockheed, this is a very rare exception.

While the pension system as a whole "owns" almost a third of the total equity in the country, no individual plan has sufficiently large holdings to make it economically rational for them to find and pursue opportunities to increase the value of portfolio companies through the use of shareholder activism initiatives like shareholder proposals, withholding votes for director candidates, or proxy contests (all with significant attendant costs of soliciting support). For example, TIAA/CREF and CalPERS, the largest pension systems, each hold approximately one percent of the total market equity. For either of them to take the lead as shareholder activists means that their beneficiaries bear all the costs of failure and stand only to be rewarded with one percent of the gains. This "collective action" or "free rider" problem challenges the question of trustee prudence. It certainly presents an unattractive alternative to the individual fiduciary who

personally cannot benefit from the fruits of his decision, but can adversely affect him, if it is unsuccessful as an investment or as a political matter.

United States employee benefit plans have almost no system for informing and being instructed by plan participants. ESOP plans often provide that the trustees will administer "ownership rights (tendering, voting)" in accordance with the instruction of beneficiaries, but there are a number of issues that make that process a complicated one. In one case, for example, "Bank of America was supposed to administer the plan according to the sole interests of the [Carter Hawley Hale] stockholder-employees. But it was simultaneously in the active, highly paid service of CHH management with a life or death interest in seeing that the shares of the plan were voted against the tender offer."[viii] Given the perverse incentives for pension beneficiaries to refrain from becoming actively involved in monitoring corporate management, no matter how great the failure, enormous conflicts of interests create an all but insurmountable obstacle.

An Ownership-Based Economy

"Ownership" of the commercial sector of the economy by the approximately one hundred million Americans having beneficial interest in the various public and private employee benefit systems provides a stable and "legitimizing" base for the power exercised by the leaders of the vast business aggregations. As Peter Drucker said, "Pension Fund Socialism should make it possible for management to regain legitimacy precisely because it re-establishes a genuine, socially anchored ownership."[ix]

The pension system represents a financial foundation for public corporations that is both widespread and long term. Furthermore, pension fund "owners" have interests exactly congruent with those of the overall society; they are the overall society. Drucker notes that "The shift to the pension fund as a radically new kind of 'owner' is a truly profound change in social and economic power and structure... the shift is far too great a challenge -- equally great as a threat and an opportunity -- to wait for accident or insurgence. How the United States responds will largely decide whether it faces rapid decline as both an economy and a society."[x]

The Pension System as "Owner"

The owners of large publicly held corporations cannot make "ordinary business" decisions. They have no right to do so, and they have no expertise in these areas. Even if they did have the right and the ability to become involved, they would have conflicts of interest with almost any company, as they invariably hold at least some of its competitors, its customers, and its suppliers. Shareholders elect the board, which in turn hires management to perform these functions. Likewise, owners should not interfere with those questions appropriate for boards of directors. If board questions are not being appropriately addressed, the remedy is through replacement of the board.

The fact that the role of shareholders is limited does not mean it is unimportant. Owners should organize themselves to have the expertise necessary to evaluate portfolio companies and to determine the appropriate level and form of their involvement. Many, indeed most, of the holdings of pension funds may be perceived as performing so well that the only involvement required by shareholders is thoughtful voting of the proxy. In situations where owners determine that change is necessary, owners have to commit the resources (i) to be informed, (ii) to deal directly with management, and (iii), in the very rare cases where discussions are not availing, to determine what kinds of individuals are needed for the board, and (iv) to nominate and elect these new board members. This means, of course, that they must also commit the resources to be able to determine when their involvement is appropriate, or, in other words, "a good investment."

There will be situations where the "emergency" intervention of owners is necessary. These will occur when monitoring is inadequate, but even with the best system of prevention there will inevitably arise circumstances requiring immediate and direct attention. In recent times, the direct involvement of the "blue chip" shareholders of American Express to force out James Robinson in 1992, a comparable imbroglio with Maurice Saatchi in 1994, Morrison Knudson's firing of William Agee, W.R. Grace's discharge of Peter Grace and the phased termination of Kmart, and Joseph Antonini in 1995 come to mind.

Over the past decade, owners have to begin to work out a structure of cooperation with other owners. This is of particular importance as a way of mitigating the classic "prisoner's dilemma" collective choice problem, whereby otherwise appropriate shareholder initiatives are not pursued because while doing so would benefit all shareholders, only one or a small group have to pay all the costs. The Council of Institutional Investors has been very effective in providing a way for large institutional shareholders to share information and resources and develop responses to issues like stock option accounting and legislative and regulatory proposals, but its ability to underwrite and organize company-specific initiatives is limited. One useful model for these efforts is that used in the development and operation of huge energy projects and venture capital investment, where one party will act as the "managing partner." Over time, this permits a "fair" sharing of the "ownership" burden, all the while assuring that a motivated and highly competent energy is actually doing what needs to be done. Based on this model, I submitted a shareholder resolution [*Attachment 1*] at the EXXON Annual Meeting of 1993. The resolution called for the creation of a shareholder advisory committee, made up of the holders of large blocks of stock. Because it provided that the company would pay the modest expenses of the committee's meetings (including the costs of the requisite information), this approach was designed to provide a way for shareholder involvement without unfair allocation of the expenses of "ownership responsibilities." The proposal received a small, but significant vote (8 percent), and has since been submitted by other shareholders at other companies. While some companies have voluntarily agreed to the creation of some kind of shareholder committee, none has been created yet as the result of a shareholder proposal.

The problems of "commercial reprisal" for private fund trustees and "political reprisal" for public fiduciaries can only be solved through a government commitment that pension fund responsibilities transcend all other considerations, despite the strong temptation to use pension money to solve other problems. Without effective and even-handed enforcement, however, this message will not be received. A vigorous and visible enforcement effort will remove the burden from those many trustees who want to carry out their statutory responsibility but are inhibited by competitive commercial realities. To the extent that government "draws a line in the sand" and puts all on notice of the priority of fiduciary obligations to beneficiaries, pension fund trustees can begin the process of becoming effective owners.

Value Added Through Shareholder Activism

Similarly, options for shareholder activism (vigilant exercise of ownership rights, ranging from careful evaluation of proxy issues to submission of shareholder resolutions and solicitation of support from other shareholders, to a proxy contest for one or more board seats) should be evaluated by fiduciaries and law enforcers on strictly economic grounds. Empirical data are beginning to be evaluated by consultants and academics. For example, Wilshire Associates and the Gordon Group are consultants who are retained by clients who are themselves "activist investors." It is, therefore, neither surprising nor convincing that both should assure CalPERS that its activist commitments have been beneficial to plan participants. Academic studies like one by Sunil Wahal are more equivocal, recognizing that there have in fact been relatively few examples of shareholder activism and no orthodoxy has emerged as to an appropriate way of measuring its impact.

A recent and extensive survey by Wahal of activism by nine public pension plans over a seven year period (1987-1993) concludes: “Targeting announcements are associated with a small but significant wealth effect for a subset of firms. However, there is no evidence of improvement in the long-term stock price performance of targeted firms. In fact, performance continues to decline even three years after targeting. Moreover, in contrast to other institutions, pension funds do not appear to significantly reduce their holdings in underperforming firms in general, or in firms that they target. Collectively, the results cast doubt on the effectiveness of public pension fund activism as a substitute for an active market for corporate control.” [xi]

Another contemporary study by Gillan and Starks reaches a similar conclusion: “We examine whether institutional investor activism by public pension funds is effective in achieving its stated goal of increasing shareholder value. An investigation of the short-term stock market performance indicates that, during certain periods, there are significantly positive abnormal returns surrounding the targeting of firms for governance reform. In contrast, in any analysis of long-term stock market performance we do not find evidence of statistically significant positive returns. This leads us to question the overall effectiveness of this form of shareholder activism.”[xii]

Activism by Public and Private Pension Funds

These studies are particularly useful in making clear what is reasonable to expect from public pension funds and what is unreasonable. Public pension funds, are governed by trustees who are either elected directly or appointed by elected officials. They are therefore sensitive to politics. They will be most involved in “fairness” issues, and will be limited by concerns about “overreaching” by government as well as more particular concerns about their involvement with companies that have local connections. Public pension funds, therefore, are well situated to raise “fairness” issues, like management entrenchment, excessive compensation, and other areas of corporate governance. Beyond this, they are limited. They are led most often by people with backgrounds in government, not in business. Their own compensation does not increase as a result of initiatives that enhance shareholder value. Their political sensitivity can lead to initiatives that are designed more for political gain than for investment returns. Only continuing pressure will create change in targeted companies and the adverse risk/return ratio for public trustees’ activism makes such constancy improbable. Public funds have been and will continue to be invaluable leaders on a limited range of issues and allies for activism initiated and maintained by others on a broader range.

Another way of understanding “reasonable expectations” for public pension plan activism is to consider how much they spend and what they purchase. By and large, the entire expenditure of public plans consists of two items: the time and expense of key personnel, and items that can be purchased with “soft dollars.”[xiii] Great discretion is needed in the use of soft dollars, because of the omnipresent fear that the state legislature will decide to exercise control over these public funds. The highly publicized initiatives of CalPERS frequently amounted to the time and travel expense of CEO Dale Hanson, General Counsel Rich Koppes and some home office back-up plus a variety of consulting services, limited to those that happened to be eligible for soft dollar payment. For political and budgetary reasons, no money was ever spent for outside proxy solicitors, advertisement or the panoply of professionals needed for a full scale shareholder effort, and victory was declared on the basis of small steps forward. For example, CalPERS issued widely publicized corporate governance “report cards” for the 200 or so largest companies in 1994-95. The grades were based on the responses they got to their requests for the boards to consider and react to the corporate governance guidelines issued by General Motors. The grading system was very process-oriented. Anyone who did not respond got an F. Any company that did respond fully to the letter from CalPERS, noting that their board had reviewed the GM guidelines and discussed them, got an A. One company, whose response was signed by every director, got an A+. The grades were not in any way based on the substance of

the companies' governance provisions, only their willingness to raise the issues and inform the shareholders that they had done so.

As for the private pension funds, let's tune back twenty years and consider Peter Drucker's prescient warnings:

> The new institutions that we have created -- the pension funds and their "assets managers," who administer and invest the pension moneys -- must have adequate management and be legitimate. Further, they must represent the beneficiaries and bear a clear-cut relationship to them. The pension funds have to be autonomous institutions.... By and large, however, the corporate pension funds have not yet even begun to organize themselves for either accountability or legitimacy. These new institutions must be free from any suspicious of conflict of interest. They must be set up to serve their beneficiaries and no one else.... What matters is that being both commercial banker and pension fund manager puts the bank into an inherent conflict of interest.... Pension funds are much too important to be run as a side line, which is all they can or should be in a commercial bank. Pension fund management requires and deserves an independent institution....[xiv]

Twenty years later we are no closer to beginning to answer the question. As a result there is no shareholder activism emanating from the private pension fund system.

"Relationship Investing"

In a sense, all investing is "relationship investing." But the term is most often used to describe the involvement of a significant shareholder. One form, epitomized by the great investor Warren Buffett, has demonstrated massive positive returns from appropriate shareholder involvement in the governance of the companies in which he invests. In several cases, he or one of his colleagues joined the board of directors. In the case of Salomon Brothers, he stepped in to take over the day-to-day operations of the firm to save it from going under entirely.

A different form is exemplified by our own LENS fund. Before LENS began, the companies in which we have become active consistently underperformed the market averages. Following our initiatives, LENS, investing in very large companies -- Sears, American Express, Westinghouse, Eastman Kodak, Scott Paper, Stone & Webster and Borden -- achieved annual total returns approximating 23 percent over a period when the S&P has done only half as well. The characteristics that LENS marshals in aid of profit are: (i) our own money; (ii) our business backgrounds (which make it possible for us to select portfolio companies that can be changed and develop the recommendations for change); (iii) our commitment; and (iv) our unwillingness to be distracted. And yet, we could not achieve these results without the support of many of the public funds and private money managers. We had an explicit working arrangement with CalPERS in 1989 in successfully opposing Honeywell's effort to amend its charter to provide for staggered board of directors' elections; CalPERS and several other prominent institutions publicly supported our initiative with Sears Roebuck. In other cases, we were able to get a broad base of support by communicating our concerns to the shareholder community. Companies with confidential voting[xv] give us the opportunity, at affordable cost, to secure up to 45 percent of the total vote for shareholder resolutions. This has given us credibility and leverage with both the shareholder and management communities.

A number of developments have made it easier to get support for shareholder initiatives. In 1992, the SEC amended the rules governing shareholder communications. Until that time, any communication to more than 10 other shareholders had to be reviewed, edited, and approved by the SEC before it could be circulated, for example. The revisions to these rules sharply decreased the costs (including the risks) of activism. The increase in the adoption of confidential

voting, most often at the urging of shareholders, has limited the real and perceived problems of commercial and political reprisal.

Pension Plan Impact On International Corporate Governance

Pension plans in the United Kingdom, the Netherlands, Canada and Japan as well as the United States are becoming massive investors in the equity securities of countries outside of their domicile. The liberalization of investment restrictions all over the world has conferred economic and political power on those countries having liquid investable funds. Countries such as France without a funded pension system have belatedly recognized their disadvantage. Carolyn Brancato estimates that UNITED STATES institutional investors increased their foreign equity holdings up to a total of $236 billion in 1993. It is the largest pensions funds (those with assets over $1 billion) that are the major holders of international equities, controlling 88.8 percent of all institutional holdings of foreign stocks in 1993.

In many instances, institutional investors are a more vigorous force for change of the governance of corporations domiciled elsewhere. This was dramatically the case with Harris Associates of Chicago taking the lead late in 1994 in ousting Maurice Saatchi. CalPERS has been prominent in Germany and Fidelity in the United Kingdom. Apparently the fear of commercial reprisal is less severe outside of one's home base. This institutional pressure may predictably have a leveling effect on the governance structures of large companies irrespective of the country of their domicile. Capital costs may be lower in markets where governance standards are highest and information is most transparent. Thus, Daimler Benz reworked its financial statements and changed its governance provisions so as to be able to list its common shares on the New York Stock Exchange. Pension funds, wherever situated, have much in common with other pension funds. As the quintessential long term investors, they can be a world wide force for governance reform.

Following the repudiation of socialism, the major industrialized countries are struggling to articulate policies to guide their economic systems. The trend to privatization of formerly government-run or sponsored entities in the United Kingdom, France and Italy indicates a move away from the traditional centralized "finance capitalism" and towards a more decentralized model. The world-wide pensions systems -- public and private -- with trustees appointed and elected by different constituencies provide the raw material with which a new diversified structure can be created.

Shareholder activism fits in well with a variety of possible successful governance systems. It can become an indispensable part of a system like that in the UNITED STATES, which relies on extensive transparency of financial data and hostile takeovers as a final -- if drastic -- market response to poor management. But it can also play an important role in other countries, like Japan or Germany, where the law, tradition, and culture are very different.

An Action Program For Pension Plans

> [The pension funds] are not owners because they want to be owners but because they have no choice. They cannot sell. They also cannot become owner-managers. But they are owners nonetheless. As such, they have more than mere power. They have the responsibility to ensure performance and results in America's largest and most important companies.[xvi]

Much of the financial history of the 1980s could be written as the rapid but unacknowledged (even by themselves) acquisition of power by pension plans. Because the pension plans did not understand at first the power conferred by their vast ownership, a vacuum was created that was filled by "takeover entrepreneurs." If the pension plans fail to use their

power responsibly in the future, it will result again in a conferral of power on to others. As the volatility of the takeover era showed, this is a significant risk. Pension funds, not only by virtue of their size, but also by virtue of their long-term perspective and their fiduciary obligation to a broad section of society, are better suited for this role than many, including arbitrageurs, takeover entrepreneurs, and the government.

But this can only work if the pension funds recognize their power and organize to become effective. CalPERS has been a leader since the early days, from establishing the Council of Institutional Investors, to both company-specific and broad-based initiatives, to the lengthy effort to reform the proxy rules. As noted above, the amendment of the proxy rules in 1992 was an enormous step forward. It is much easier for shareholders to communicate with each other. Significant obstacles remain, however. "The extent to which the federal proxy rules frustrate shareholder democracy has been chronicled extensively elsewhere. Many of these issues were brought to the attention of the SEC by the CalPERS letter, but the SEC chose not to address them. In spite of its continued re-examination of the regulatory system and its never-ending series of amendments, the SEC continues to limit shareholder participation in corporate governance both through sins of commission and omission in connection with its proxy rule. Accordingly, the rules remain an unauthorized and misbegotten regulatory endeavor."[xvii] A beginning agenda of what remains to be done in other federally regulated areas was set forth by Professor Alfred F. Conard.[xviii] The Council of Institutional Investors has been very effective in pressing for pension plan legislative and administrative reforms.

One of the most pressing is prompt and unequivocal definition of the "exclusive purpose" rule of ERISA (and comparable rules applicable to public pension funds under the laws of most states). The language itself is clear: the pension plan must be administered "solely...and for the exclusive benefit of the plan participants." What is unclear is what that means in real-life application. The Department of Labor has been firm in stating that it does not mean that the plans should be administered for the employees' benefit as employees or as members of the community, but for their benefit as pension plan beneficiaries. The only goal is the long-term health and growth of the pensionassets.

But there were inevitable comprises in drafting and administering ERISA, and one was the creation of what has been called "the fundamental contradiction of ERISA."[xix] Plan sponsors were given the right to appoint and control plan trustees. Despite the fact that the legislative history makes it clear that the statute is intended to incorporate the strictest fiduciary standards of the common law, and then add additional strictures to them, from the outset, the position of trustee has been equivocal. Nominally an independent fiduciary, in practice trustees serve the person from whom they are supposed to be independent. We have earlier considered Peter Drucker's twenty year old perspective that pension fund management is too important to be a secondary activity of a financial institution. Drucker notes, "But setting up pension fund management as an autonomous institution would only be the first step. It is equally important that pension funds be organized for legitimacy and accountability."[xx]

There is no need for the pension funds to wait for governmental action. The pension fund industry generates sufficient fee revenue to support an industry of special purpose money managers. Pension fund trustees can make a difference by simply insisting on retaining money managers that limit themselves to pension funds as clients. What this means is that existing fiduciary banks can rationally select either to continue their multifaceted relationships or to limit themselves to serving as employee benefit plan fiduciaries -- there is a large enough market under either alternative to support their operations. Further, there would be opportunity for new "special purpose" pension-fund-only trust institutions.

Who will start this effort? Once again, the public plans are most likely to lead the way, as they do not run the risk of commercial reprisal in redirecting business. When the public plans have enabled the building of a "pension fiduciary industry" the private plans will find themselves at

a competitive disadvantage and may be forced to follow suit. Beneficiary pressures may abet the development of an independent fiduciary system.

Further steps along the lines proscribed by PWBA chief Olena Berg in July 1994 may be necessary. “[T]he Department believes that active monitoring and communication with corporate management is consistent with a fiduciary’s obligations under ERISA where the responsible fiduciary concludes that there is a reasonable expectation that such activities by the plan alone, or together with other shareholders, are likely to enhance the value of the plan’s investment, after taking into account the costs involved.”[xxi]

While PWBA here plainly authorizes the expenditure of funds on appropriate shareholder initiatives, there will need to be precedent, publicity and, ultimately, judicial authority before risk-averse trustees become comfortable risking their beneficiaries’ money. In the public plan arena, the problem is politics -- state legislatures will not like their pension systems incurring all manner of expenses that have not been legitimated through the appropriations processes. Furthermore, the targets of these initiatives are sure to have substantial political clout.

Large fiduciaries are bureaucratic institutions with the same inherent weaknesses as large companies. How can we protect ourselves against simply substituting one bureaucracy for another, increasing costs and having little or even negative impact on efficiency? Fiduciaries have experience in engaging the services of professional advisors on a competitive basis. To the extent that shareholder activism becomes perceived as simply another potentially value-adding service, providers can be competitively selected and evaluated. The market place will be the ultimate judge.

Conclusion

The ancient Greeks believed that in order for democracy to succeed, citizens had to devote their full time to participation. We now have a shareholder who does devote full time to ownership, which is his equivalent of citizenship -- the pension fund manager. His size makes possible, and his fiduciary obligation makes enforceable the exercise of this citizenship on behalf of those real citizens, the pension beneficiaries. They are the citizens whose interest in the future makes them ideal stewards of America's corporations.

ENDNOTES

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[i] Peter F. Drucker, *Harvard Business Review*, March-April 1991, 316,318 (emphasis added) (hereinafter Drucker 91MA)

[ii] This is money held and managed by intermediaries -- pension funds, insurance companies, mutual funds, endowments, etc. -- for the benefit of individuals (investors, pension plan participants, etc.) or non-profit organizations (charities, universities, etc.). All statistical material is provided from The Brancato Report on Institutional Investment, Volume 2, Edited on 1 January 1995, unless a different edition is indicated.

[iii] During the first quarter of 1995, the Public Employees' Retirement System of California ("CalPERS") indicated an increase in its targeted percentage of equity investment to 63 percent.

[iv] Brancato, 1993

[v] Charles D. Ellis, "Investment Policy" (Dow Jones-Irwin, Homewood IL, 1989), p.5 and Stephen L. Nesbitt, "Rewards From Corporate Governance," Wilshire Associates, February 12, 1992 and "Long Term Rewards From Corporate Governance," Wilshire Associates, Jan. 5, 1994.

[vi] In the 1986 Federal Employees' Retirement System Act, Congress provided that federal employees may elect to invest in an equity index but not in individual companies.

[vii] Roberta Romano, Public Pension Fund Activism in Corporate Governance Reconsidered, *93 Columbia Law Review*, 795 (#4, May 1993) and Politics and Public Pension Funds, *The Manhattan Institute*, 1994.

[viii] Benjamin J. Stein, A Saga of Shareholder Neglect, *Barron's*, May 4, 1987, pp. 8-75.

[ix] Peter F. Drucker, The Unseen Revolution, How Pension Fund Socialism Came to America *, Harper & Roe*, 1976, p. 92 (hereinafter Drucker 76).

[x] Peter F. Drucker, Can Pension Funds lead the Ownership Revolution? *Harvard Business Review*, May-June 1991, p.169 (hereinafter Drucker 91MJ).

[xi] Sunil Wahal, Public Pension Fund Activism and Firm Performance, *University of North Carolina*, November 1994.

[xii] Stuart L. Gillan and Laura T. Starks, Relationship Investing and Shareholder Activism by Institutional Investors, *University of Texas*, February 1995.

[xiii] "Soft dollars" are a sort of frequent flyer miles for stock transactions, and are an off-budget resource that can be used to pay for research (rather broadly defined).

[xiv] Drucker, 1976, p. 85 et. seq.

[xv] We have found a very significant difference at those companies that give their shareholders the protection of confidential voting. At companies that insist on knowing how their shareholders voted (and that often use this knowledge to push anyone voting against management to change their votes), it is far more difficult to get a strong showing of support for shareholder initiatives than at companies that guarantee thatall votes are confidential.

[xvi] Drucker, 1991 MA, p. 324.

[xvii] Jill E. Fisch, From Legitimacy to Logic: Reconstructing Proxy Regulation, 46 *Vanderbilt Law Review,* 1129, 1198 (1993).

[xviii] Professor Alfred E. Conard, Beyond Managerialism Investor Capitalism?, 22 *Michigan Journal of Law Reform*, 117, 1988

[xix] See, for example, Daniel Fischel and John H. Langbein, ERISA's Fundamental Contradiction: The Exclusive Benefit Rule, *The University of Chicago Law Review*, September 1988 (55:4), pp. 1105-1160.

[xx] Drucker, 1976, p. 88

[xxi] From Interpretive Bulletin 94-1, Title 29 - Labor XXV - PWBA, DOL, Part 2509