Organization for Economic Co-operation and Development Symposium on The Role of Disclosure in Strengthening Corporate Governance and Accountability

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Session III Vehicles for disclosure: How well do existing vehicles for disclosure serve the needs of shareholders and the market?

Theme III: How well do private meetings with analysts and institutional investors work ?

It is universally acknowledged that the corporate system works best when it conforms most closely to its theoretical ideal of management effectively being accountable to ownership. When corporations are owned by hundreds of thousands of shareholders, the diseconomy of any single owner undertaking the costs and risks of monitoring on behalf of the whole class (referred to as the "collective action problem") has impeded, indeed — until the most recent times — has foreclosed fulfillment of the theory. What is needed is a system in which the "monitoring" shareholder has incentive (or, at least, the absence of disincentive) to commit resources to the research and supervision necessary to optimize management functioning.

Private meetings between management and institutional investors have two endemic problems:

Most institutions have or want to have other business relationships with the portfolio company. Also, the meetings are apt to generate valuable information which the institutions can use to their personal benefit in the market place. Conflict of interest tends to dominate the meetings. The appearance is that institutions having direct access to companies have a monetary advantage over individual investors. It seems inevitable that insiders appropriate too much of corporate wealth — CEO pay, lawyers' fees in class actions. It is, therefore, of serious concern to institutionalize insider trading. Ultimately, the diversion of wealth will threaten the legitimacy of the corporate system in a free society. The problem is how to create suitable incentive for ownership involvement, starting with informing themselves, without creating unjust enrichment. The great investor from Omaha, Nebraska, Warren Buffett epitomizes the kind of monitoring shareholder whose involvement enhances the value of the whole enterprise. In this regard, as in so many others, Buffett has devised a satisfactory structure. Oftentimes — Champion Paper, Salomon Brothers, USAir — he will negotiate participation with management through a special class of equity security. These convertible preferred stocks assure Buffett both of downside protection and income as well as upside gain. He has a better deal than ordinary shareholders [on close analysis, it is clear that his interest is perceptibly different from that of an investor holding only common stock], but they have a better deal than they had absent Buffett's involvement. ("A rising tide lifts all the boats.") The market makes a calculation —the dilution caused by Buffett's preferred position discounted by the rise occasioned by his involvement — pre and post Buffett common stock prices. Unhappily, one cannot create a world system based on the availability of an infinite supply of Warren Buffetts.

There are critical conceptual and legal differences between information that is publicly available and information that is not. It is widely felt that the scope and quality of non-public information is directly related to a lower cost of capital. Much of this concerns the detail and scope of information that corporations are required to disclose. "The U.S. system of investment should offer greater access to information that better reflects actual corporate performance. Both investors and mangers should be encouraged to supplement strictly quantitative measures of investment and performance with assessments of qualitative factors, such as the quality of the firm's work force or its level of technological sophistication." , Michael E. Porter, Changing the Way America Invests in Industry, Journal of Applied Corporate Finance, Summer 1992, 4,12. Shareholders have the right both individually and as a class to bring suit against corporations that make misleading representations about future performance. There is a continuing effort to

achieve a harmonious balance between full disclosure and inaccurate projections: " To encourage… greater external disclosure of important leading indicators of long-term shareholder value while maintaining a viable private right of action for victims of securities fraud, the SEC should extend the existing safe harbor from securities fraud private rights of action for forward looking statements… In addition, the safe harbor should be extended to cover disclosure of certain classes of non-financial information… develop principles for measuring certain salient categories of non-financial information, including human resource investment…", Report of the Sub Council on Capital Allocation of the Competitiveness Policy Council, III (1995)

It is assumed that the private meetings with institutional investors will include information about the corporation that is not public. The same calculus so evident in the Buffett situation should be applicable in theory to all meetings with shareholders — whatever an individual investor learns of special or inside importance should be equivalent to the increment in the general value of the company's equity due to his involvement. The transition from Buffett's explicit "tax" to the making equivalent of "insider profits" with corporate benefit is not a comfortable one.

Profiting from traditional inside information ("there will be a merger…", "second quarter earnings will be below expectations….", etc.) seems unfair and is universally condemned (except surprisingly for some classical economists and the Editorial Page of the Wall Street Journal). Ironically, the kind of information that is ultimately the most valuable is of a different kind and is not susceptible of simple quantification. It is the subjective conclusions of the experienced observer. Getting a "feel" for the Chief Executive Officer is of vast importance; there is a detectable tone to the appearance of factory and office space; there is a message in the demeanor of white and blue color employees. The SEC has taken a rather cavalier and successful attitude towards monitoring and punishing inside trading. It disdains resolutely from defining exactly what conduct by whom is prohibited. Instead, it relies on the language made famous by the Supreme Court in a different context — "I can't describe it, but I know it when I see it." Occasionally the Commission limits itself to prosecute those with a fiduciary relationship to the company; other times, it bases its cases on the existence of "material non public information" no matter how far removed the trader was from the company. The result is occasionally unfair, but the in terrorem approach has had the virtue of getting everyone's attention.

There are two kinds of investors who have neither the inclination nor the interest to profit from conflicting interests.: the first is the public pension plan that invests in equities through an index and the second is an "insider" who is subject to statutory limitations on liquidity (Sec & Ex Act, sec 16(b)). A prototype of the first is the Public Employees' Retirement System of the State of California ("CalPERS"), and of the second are investment funds controlled by "activist investors", typified by individuals such as Michael Price ("Price") and George Soros ("Soros"). Public funds are not in the business of offering services to outsiders; index fund investments are not made through analysis or tip but by formula. The individual activists are required to make public their intentions when they acquire percentage holdings over a particular level — often 5% — or when they intend merger or acquisition. Often, their capacity to realize gain on short term (less than six month) trading profits is restricted.

If objection to allowing full access by institutional investors is based on the concern that they may realize profit from information not publicly available, access could be conditioned on their willingness voluntarily to accept the restrictions imposed by law on the statutory "insiders". It would seem eminently worthwhile to create a new class of shareholder and analyst — one having access to a company and non public information, but only on the condition that they voluntarily abandon profit from purchases or sales within six months of the visits. Would the increase in information and influence translate into sufficiently higher probability or profits to compensate for the time and expense? That is an appropriate question.