

HOW ACTIVE SHAREHOLDERS DRIVE COMPANY PERFORMANCE

WHAT WILL BE THE IMPACT OF ACTIVE SHAREHOLDERS? A PRACTICAL RECIPE FOR CONSTRUCTIVE CHANGE

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September 21, 1998

ABSTRACT

The emergence of institutional investors (the New Owners) having controlling positions in the publicly held American companies has revived the legendary authority and responsibility of ownership for corporate functioning. The primary responsibility of active shareholders is to assure that their companies exist in harmony with society's rules. The corporate tendency to dominate other elements in society can be mitigated most effectively by informed shareholders. To the extent that companies have a constitutional structure enabling shareholders to hold managements accountable, they enjoy the lowest cost for new capital in the modern marketplace. This phenomena should create a market place premium for good governance, but this has been frustrated by the failure of government to enforce its own rules. Trustees for the pension funds of private companies the largest New Owner with 20% of the total outstanding usually have other business relationships with the companies held in their portfolios. Clearly this inhibits active monitoring. Notwithstanding the clear requirement of the law that trustees owe their beneficiaries undiluted loyalty, all levels of government have acquiesced in the non-action of private pension trustees. Government action is now needed to eliminate this dysfunction and to let the market gradually create new solutions.

Shareholders are the only one of a corporation's constituencies that has the power and authority to control its destiny. They profit to the extent there is surplus after all commitments are satisfied. Shareholders lose when all obligations to other constituencies cannot be discharged in full. Any class so situated should both have the responsibility for creating the language of accountability within which the enterprise functions and the authority to do so. To the extent there is any question whether the commitment of corporate resources is in aid of long term profit maximization, it is important that only owners are entitled to give away their own property. The fragmented nature of shareholding over most of the twentieth century has made any question of ownership responsibility moot. This unignorable practical problem has been reinforced by theoretical concern against imposing obligations on a class, one of whose most attractive attributes is limited liability. It is not surprising that shareholder involvement has been largely anecdotal. James Willard Hurst, the foremost legal historian, summarized that situation as of 1970 in these words: the general failure of shareholding to supply the steady surveillance by which stockholders were supposed to legitimate the power wielded in business corporations."^[i]

This conclusion needs re examination in light of the unanticipated^[ii] emergence during the last quarter century of the New Owners, the modern institutional investors who hold more than 60% of the outstanding stock in the largest U.S. and U.K. companies. When I refer to shareholders or New Owners, I take the public and private pension funds to be an appropriate proxy for the whole class of institutional owners.^[iii]

These New Owners have characteristics that importantly bear on discharge of their legendary function of monitoring. The New Owners are

- Universal in the sense of owning all public companies in all industries;
- Long term in holding period (indeed, the pattern of indexation suggests virtually permanent ownership);
- Global in outlook, with increasingly similar expectations for financial performance and reporting in all countries;
- Humane in the sense that their beneficial owners comprise a substantial portion of the population and have the explicit human interest in a clean, safe and civil society, as well as adequate retirement income; and
- Legal. They are not flesh and blood humans with the thousand natural shocks that flesh is heir to. They are constructs of law with the scope of their responsibility being subject to periodic definition by the legitimate law maker.

Much has been written about the difficulties that the institutional investors face - of the free rider problem, of problems of fiduciary prudence and risk / reward, of conflicting interests in other relationships with portfolio companies, of the disinclination of the New Owners to expose themselves to the risks of activism, and, not least, of the utter lack of qualification that the current New Owners have for the challenge of effective shareholder involvement. We should no longer ask whether the institutional shareholders want the responsibility of ownership, nor even whether with their present staffing and configuration they are suitable to exercise it. Our society can not afford corporate owners who do not organize themselves to be responsible with the same tenacity and ingenuity they use to assert their prerogatives. Ownership implies responsibility. Perhaps it is as simple as how the question is posed. Why should not a class of highly compensated trustees with enforceable fiduciary obligations to half of society be required to educate and staff itself so as to function as a responsible owner?

Milton Friedman has provided the orthodox definition of ownership responsibility: Few trends could so thoroughly undermine the foundations of our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for their stockholders as possible.[iv] He goes on to require that this value maximization must be accomplished within the rules. Shareholder value creation requires not only a commitment to obeying the law, but further a sensitivity to the changing concerns of the society.

The recent intense confrontation between the U.S. tobacco industry and the whole spectrum of federal and state legislative, executive, administrative and judicial systems provides illustration of the corporate tendency to influence even to dominate the creation of public consensus that is ultimately the basis for law. Indeed, the tobacco drama suggests the most serious of problems an industry with sufficient power and skill to be able to co-opt the political process. The tobacco industry in the United States has long been a welcome corporate citizen. But at some point in recent time the American public acquired a prevailing concern with over half a million fellow citizens dying of tobacco related causes every year. In recent years, there has been a barrage of law suits and proposed new laws exposing the fundamental chasm that separates the cultures of commerce and public health. By pausing for a careful look at the power equilibrium of the tobacco industry in the U.S. today, we can find much to inform our conclusions about company performance and the shareholders role.

Steve Goldstone, Davis Polk lawyer turned tobacco company CEO [RJR], recently set forth a concise version of his: I know these guys [tobacco industry critics] like to put this in moral terms, but if they can't convince Congress to ban this product, we don't have any choice but to sell it. As far as I am concerned, the day after any bill passes, we'll be selling cigarettes. [v] (emphasis added)

This comment was made (by happenstance) in the context of an unexpected tobacco industry success (June 1998) in defeating Congressional action which would have increased the price of

cigarettes by \$1.10 a pack and spent the proceeds on smoking related health costs, an anti-smoking advertising campaign and on health research. This supposedly popular bill was killed by a \$40 million advertising campaign large even by American standards that managed to persuade voters that the bill was about boosting tax revenues and expanding bureaucracy rather than on curbing smoking among the young.[vi] The tobacco industry has long demonstrated great power over the workings of the governmental process in the United States. Soft money contributions from 1/1/97 through 6/30/97 of \$13,972,640 mostly to the Republican Party[vii]; large campaign contributions to key legislators; and huge retainers to former leaders / now lobbyists. The Washington law firm that [former Democrat Senate Majority Leader] Mitchell and [former Republican Senate Majority Leader] Dole are employed by Verner Lipfert -- has already collected \$10.2 million in lobbying fees from the tobacco industry. Last week, the industry got its money's worth [Mitchell was among the strongest proponents of the ads][viii]. Nor is the industry particularly fazed by the seeming apostasy of its bought supporters in the short term - From the tobacco industry's perspective, the abandonment of its interest by so many of its putative friends in Washington is an example of the sort of political hypocrisy that steals the breath from mere mortals 'This is the greatest argument against the Common Cause view of money in politics. [Newt Gingrich] says. 'I don't care how much they gave in the past, or how much they will give in the future. The cigarette makers do not deserve our protection.' [ix]

At just the time Newt Gingrich was reading today's polls, his Senate colleague Mitch McConnell, Chairman of the Republican Senate Campaign Committee, was preparing tomorrow's. Money and persistence are the ultimate Washington weapon: On the day the Senate killed comprehensive tobacco legislation, Senator Mitch McConnell stood up at a closed-door meeting of Republican senators to deliver good news: The tobacco industry would mount a television ad campaign to support those who voted to knock off the bill. Such ads, Mr. McConnell says now, 'would be generally helpful to people who decided to kill this bill as a big tax increase on working Americans.' [x] While Goldstone's comment that he is obligated to sell cigarettes unless their sale is made illegal has surface credibility, it acquires a different hue when one considers the extent of his power to determine what the law is. Not only does Big Tobacco participate largely in the conventional electoral process, but it also commits defining resources for creating the public opinion that underlies popular consensus.

Goldstone brings a lawyer's perspective. If it is legal not only is it acceptable it is inappropriate for management to probe any further. Others have a different view. I don't want to live in peace with these guys, [Dr. Kessler, former FDA Head and a widely respect critic of the tobacco industry] explained. 'If they cared at all for the public health, they wouldn't be in this business in the first place. All this talk about it being a legal business is euphemism. They sell a deadly, addictive product. There's no reason to allow it to conduct business as usual. Though Goldstone is familiar with the argument, it still flusters him. 'I have no moral view of this business,' he told me. 'I view it as a legal business. You shouldn't be drawing a moral judgment about a business our country says is perfectly legal and is taxed like crazy by it.'?[xi] Goldstone hedges his bets by reminding everyone how convenient are the tax revenues produced by tobacco. He might have gone further to discuss the industry's inspired program of charitable contributions to high visibility activities associate the company [Philip Morris] at every opportunity with positive social values, institutions and ideas, and if it behaved like a sterling corporate citizen, people would overlook the unfortunate tendency of the core product to shorten life expectancy.[xii]

Goldstone sees his job as creating a receptive environment for his company through public relations, lobbying and financing the election of favorable officials apparently without financial, governance or ethical restraint - and in maximizing its immediate profits. Even this, admittedly legalistic and narrow, approach is not problem free. The market simply will not attach a multiple to earnings from tobacco sources that is competitive. This is why the tobacco industry embarked on its apparent misguided efforts for settlement with the State Attorneys General: The opportunity was so unique I was able to go to the board, to the shareholders and to the employees who own stock and say What is the point of producing earnings if nobody puts a value on them? We're getting Pyrrhic victories in these cases, because nobody is putting a value on our earnings. Call it

Coke envy: the tobacco companies are revenue machines, and yet the stock market fearing the instability of endless litigation is not embracing them as they do other consumer products giants like Coca-Cola. Goldstone the manager can not be content simply with producing great earnings; he has to concern himself with the multiple placed on those earnings in the market place to produce value for his shareholders. This is where the two components of governance legitimacy and competitiveness converge. The market place appears to penalize companies whose functioning affronts societal standards. This raises the cost of capital and tends to make those companies uncompetitive. We have created a primitive model of this behavior on the Internet – <http://ragm.com>. The composite Tobacco Co. multiplier at the end of 1997 was 17.6 while Coke managed more than twice as well with 39.9.

It would appear as if the managements of U.S. tobacco companies have made a stupid strategic choice in choosing to risk their owners' values on an income stream deemed suspect by the public and politicians. The oldest U.S. tobacco company American Tobacco some ten years ago diversified its operations out of domestic tobacco, changed its name first to American Brands and then to Fortune Brands. The market welcomed the newly conceived venture and provided superior returns for its shareholders. Is it enough for shareholders simply to rely on market pressures to drive management out of societal threatening activities? Society does not speak with a single voice. Gambling and liquor earnings are highly valued; persistent conduct classified as criminal has not prevented GE from being the most highly valued corporation in the world; UK companies purchase tobacco operations from America without stock market loss or moral encomium. One of the principal challenges for boards and top management is to correctly anticipate trends and optimally deploy corporate assets. Ultimately, we have no choice but to accept the law as the only legitimate indicator of society's judgement.

But what are the new owners to do under circumstances suggesting that corporate power has moved too far in its influence over the political process and to thereby call into question the legitimacy of the law. This has been dramatic in the upward explosion of CEO pay and the abuse of corporate power to overwhelm monitors and regulators. The Business Roundtable, an organization comprised entirely of CEOs, organized an effective lobbying effort culminating in an actual vote by the U.S. Senate (88-9) directing the hitherto impeccable and independent Financial Accounting Standards Board not to take into account as an expense the present value of executive stock options. The current level of executive compensation in America represents one of the largest non-violent transfers of wealth from one class to another in recorded history. This combination of both economic and political power in the pivotal area where management's conflict of interest (i.e. how much do they pay themselves?) is most acute, illustrates the need for some kind of constraint on corporate power. In light of the co-optation of government by business in critical situations, there is plain need for accountability to some other entity, capable of independence and influence. Business dominates outside regulators, so the only feasible restraint is from within the corporation itself. There is no constituent other than the shareholder/owners who combine the motive, the independence and the power to articulate limits and to monitor and enforce compliance.

A response by shareholders requiring minimal commitment[xiii] is divestment. The New York State Common Fund has stopped new purchases and cut its tobacco holdings to 1/2 of 1% of the fund total; Florida and Maryland have also divested. Many other state and city pension funds are either freezing existing levels or partially divesting. Divestment creates public attention that may be politically useful it is noteworthy that the sole trustee of the New York State Common Fund is an elected official but it is difficult to understand how transferring ownership from people who disapprove of tobacco to those who don't is in aid of a policy of abolition. Beyond this lies a serious question of conflict of interest. Does the social agenda take precedence over the obligation of trustees' to manage for the exclusive benefit of plan participants. The U.S. Department of Labor has consistently taken the position that divestment is illegal for private employee benefit plans under ERISA. Partly as a result of outside pressure (a 10% shareholder vote in 1997), the well regarded Sara Lee Corp. sold its Doewe Egberts Van Nelle Tobacco unit to Britain's Imperial Tobacco in June 1998. Divestiture of stock or of an operating division does

not, however, answer the basic question as to how stockholder involvement can be effective to influence their company's involvement in the political and government process.

There is another actor in the drama. Law making in America is a complex dynamic process. There are multiple levels of government; laws, proposed laws, regulations have different implications, announced policies can have the full force of government, especially when propounded by a prosecutor with authority to commence litigation. Much attention is placed on Washington D.C., but the original proposed tobacco settlement (Spring 1997) was pioneered by the Attorneys General of several states. One of the wisest of these, Richard Blumenthal of Connecticut, neatly idealized a role for American law makers in world wide corporate governance:

In the end, my feeling is that pressure will keep the industry at the table, but looking abroad, that same kind of pressure may not exist beyond the borders of our country. And so, I think in providing a model of how we can make a rogue industry obey the law change the law that it makes society healthful [sic]. We can provide an example for the countries of the world who do not have the legal systems that we do here that can vindicate those rights, and we can set a model of what free enterprise really ought to be, not just arbitrarily setting regulatory bounds, but really setting realistic goals that can be met so our society ultimately is the beneficiary and we can truly as we have said as Attorneys General save a generation and children who otherwise would become victims now at the rate of 3,000 a day of a lifetime of addiction and diseases that tobacco causes.[xiv]

Blumenthal poses a conundrum for the New Owners. It is they to whom he is talking. They should not be able to take refuge in merely transferring tobacco operations from one society where they are penalized to another where they are not. Ultimately they will have to make holistic judgements. Government pressure is not self-executing. Somebody has to do something. Americans have little confidence in direct government intervention. The century long experiment with public ownership of industry has failed on many counts. (i.e. the pollution standards in Eastern Europe) The New Owners will have to reconcile themselves to the vagaries of a commercial world in which either they are essentially reactive to the various indication of public will or they will have to change to an activist mode. This is a difficult and continuing process beset with errors and the need to reverse and begin again. There is no formula for comfortable compliance with changing and fickle seeming notions of appropriate corporate behavior but persistent and respected effort to restrain power when it threatens individual freedoms may be the only tolerable guiding star. The case of tobacco dramatically illustrates the continuing pressures on corporations to operate within a framework of public acceptance.

The United States has a written Constitution, which provides explicit structure within which the power of the state is to be exercised. The most prominent non-governmental institutional power in existence at the time of the Constitution's adoption was that of the church. The first article of the Bill of Rights explicitly guarantees the separation of church and state. Interestingly enough, the word corporation is not mentioned in the Constitution. While church power has been kept out of the on going political process, there has been no institutional recognition of the comparable problems presented by corporate power. Indeed, U.S. corporations have for over a century been accorded precisely those same rights whose securing for individuals in the Bill of Rights to the federal Constitution is considered the apogee of humanist political theory. These rights have been extended again, exactly parallel with the rights of individuals to political speech and contributions.[xv] Rather like a separate and distinct system within the state, corporations have been treated like enlarged individuals. Notwithstanding Baron Thurlow's celebrated aphorism that corporations have no body to incarcerate and no soul to save, we have chosen to carry on the human simile and pretend that criminal law is an effective sanction against unacceptable corporate conduct. Corporations have dynamic forces that cannot be ignored, among them to get larger and to maximize profits. There never has been suggestion in the chartering grant by the state that the corporate creature will have absolute license to externalize its functioning on to the state. There is not even a concept as to any limits or the allocation of costs arising from them. We have been slow to come to grips with the reality that we have created in corporations a dynamic

form of life and energy that requires accommodation in a polity hitherto largely populated by flesh and blood citizens.

A place of beginning is to assure that the public and law makers have access to all the information relevant to corporate functioning. Our efforts to correct the dysfunctions of unaccountable corporate power must be based on a more focused approach grounded in market theory and our understanding of the nature of the corporation and its accountability structures. A straightforward focus on internalizing costs and assuring all stakeholders free access to relevant information relating to cost internalization meets both these conditions and would offer a market based approach to making the corporation a more socially responsible entity. Indeed, actualizing these two conditions of a socially efficient market should be the central focus of any corporate responsibility program.[xvi]

A Bill of Corporate Rights & Responsibilities needs to include an undertaking to respect the law as the authentic expression of public will. This cannot be simply a matter of cost effectiveness, where the corporation is free to calculate whether the cost of compliance is worth the risk of being caught and the incident fines and expenses. A corporation's remedy when confronted with what it considers an inappropriate law is to participate openly and respectfully in the process of changing it. As mentioned in our review of Tobacco, corporations must accept the responsibility of full public disclosure of the impact of their functioning on society. The integrity of laws depends on their being based on the best available information to which all parties have access. Corporations must be restrained in their relationships with the electoral and political process. Corporations have become participants in the political system, although they do not actually vote. There is the very real prospect of corporate impact dominating the government process and, thereby, ultimately (but surely) undermining its legitimacy and popular support. The long-term health of corporations requires a society in which the system of law enjoys broad and uncynical support of the citizens. I have elsewhere referred to these three commandments as an interrelated and self-reinforcing conceptual basis for corporate accountability. Corporations are required (1) to obey the law, which is based on (2) informed action by a legitimate government that (3) has not been improperly influenced by corporate power.[xvii]

What is of transcending importance is the recognition of a goal the existence of corporations in a society which has full knowledge (or as much as possible) of their impact and the uncoerced capacity to make laws defining the acceptable parameters of co existence. If society can foster an ideal framework, where among the corporate constituencies can we find the capacity for motive, for being informed and the power for effective compliance? Alone among the corporate constituencies[xviii], the shareholders have the motive and the power to hold corporate managements effectively accountable. Only owners can decide whether and to what extent to defer profits. In recent times, ownership has been reagglomerated into the hands of relatively few New Owners.

The pursuit of long term value optimization requires appropriate attention to the interests of employees, customers and society. McKinsey & Company has considered this question at considerable length in several recent articles. One of them entitled The Virtuous Cycle of Shareholder Value Creation concludes: Shareholder value is still a controversial topic in Europe, but we believe that embracing it is an essential ingredient of any plan for European economic reform. There is overwhelming evidence to support the view that shareholder value should be the explicit goal of all corporations. A shareholder mindset benefits not only the shareholders themselves, but society at large, setting in motion the virtuous cycle of value creation, job creation and wealth creation.[xix]

Shareholder activism can be shown to be profitable. The great investor from Omaha, Nebraska, Warren Buffett epitomizes the kind of monitoring shareholder whose involvement enhances the value of the whole enterprise. He personally salvaged the rogue Salomon Brothers from the bankrupting implications of its illegal activities. Buffett has devised a satisfactory structure by which he can be compensated for his efforts. 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, 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, but his experience corroborates the worth of an effective monitoring shareholder.

We have been very much involved over the last dozen years as an activist investor in many of the great companies of America - American Express, Westinghouse, Eastman Kodak, Sears, Stone & Webster, Tenneco, Corning and Waste Management among them. At first with the investment of our own money and latterly with over one hundred million dollars of clients' funds, we have using the name LENS to connote our mode of focusing on underperforming companies deliberately involved ourselves in situations where change appears necessary. LENS has just completed its sixth year as a special purpose partnership dedicated to proving that a company having effectively informed and involved owners is worth more than one without. Full details about LENS are available on the Web - <http://www.lens-inc.com>, so I will conclude here simply - activism adds value for special purpose investors who are untrammelled by other commercial arrangements or ambitions with the focus companies. I take substantial comfort in the work of McKinsey & Company because of its demonstrated value to company managements around the world. McKinsey has developed the first matrix to assign values attributable to good board of directors' governance practices. While the methodology is tentative, the conclusion that a sample of investors and top managers place an 11% premium on the value of companies perceived as having good governance is unignorable. The ultimate challenge is how to induce the new owners to commit the resources necessary to monitor portfolio companies.

A company having informed and effectively involved owners is worth more than one without. Individual activists can make an adequate profit so as to justify their initiative. Why then can we not sit back, notice the ascending activist trend and confidently expect the market to do its magic.

Unhappily, the market is polluted by mixed messages from government. On the one hand, ERISA provides, in words as clear as language permits, that trustees must consider exclusively the interests of beneficiaries; on the other hand the preponderance of ERISA fiduciaries have other commercial interests with portfolio companies and a pervasive concern not to act in a manner which would be viewed as threatening by CEOs in whose gifts lies the award of lucrative business. I can not cite a single example of shareholder activism or a shareholder resolution over the last fifteen years in the United States[xx] that was publicly identified with a private pension plan or one of its money managers. The Department of Labor's path breaking pronouncements requiring trustee involvement are followed, not by those it regulates, but by others. Shareholder activism, therefore, is not an expression of the 30% of total ownership represented by pensions; it is rather the 10% controlled by public pensions and the occasional entrepreneur.

Public pension funds particularly CalPERS and SWIB[xxi] have ensured that important issues are raised, but the public plan system is not credible as the unique element in a constructive activist program. While not subject to business pressures, public plans are strongly influenced by non commercial considerations Holocaust recovery from the Swiss Banks for New York City, Tobacco for New York State are the recent fruits of the month. Public plans are staffed by civil servants without experience and, therefore, credibility in the business sector; nor, as a political matter, are they in a position to follow through on initiatives. They can raise consciousness of problems, but their internal political dynamics makes it virtually impossible for even the most committed public plan to commit resources for lawyers, advertising and specialists that is necessary for success in a confrontational context. So long as the private pension system representing 20% of the total outstanding is allowed to eschew activism and boycott the efforts of other shareholders, ownership based governance will be only marginal. I am reminded of the wise aphorism attributed to a former Commissioner of the S.E.C. If CalPERS didn't exist, The Business Roundtable would

have to invent them. This cynical comment points out that corporate hegemony is best served by the appearance of effective regulation and the reality of utter license. Shareholder activism has been given much credit for increases in competitiveness, in particular but the results must be suspect when the really critical issues like mode and amount of executive compensation are not addressed.

If the language of the ERISA statute is so plain and the evidence of value added through activism so indisputable, why have not disgruntled activists found relief in court? And why has the Department of Labor, the bed rock of fiduciary concern, not enforced the law? There are several reasons most of them of the kind that appeal only to lawyers. There is the problem of proof. How can it be proven that the vote, or failure to vote, of a single shareholder caused a specific amount of damage. Even in those exceptional cases, where a particular shareholder's vote was the difference between whether a motion carried or failed, how can it be proven that the fate of this one resolution was the reason that loss was incurred. And votes are the most tangible of shareholder prerogatives - the problems of proof and causality become more attenuated when talking of questions like replacing board members or changing strategy. If the courts are to be the institutional instrument for articulating and enforcing a National Law of Ownership, the legal issues will have to be framed differently. An affirmative duty of owners under certain circumstances need be articulated either by court or legislature. Stated perhaps too bluntly - If a corporation has underperformed^[xxii] drastically^[xxiii] for a substantial period of time it can be presumed that the fiduciary shareholders^[xxiv] have failed to take appropriate action to safeguard the interests of their beneficiaries^[xxv].

This formulation would effectively place on ERISA fiduciaries^[xxvi] the burden of proving that failure was not attributed to their inaction. Many questions of process would need be addressed - should it be enforceable by courts or by executive branch agencies, should it be a governmental or a private right? However answered, this may be the only way to cure the present dysfunction.

Because of the failure in the United States to include any specific mention of large corporations in the Constitution, we have no road map to guide us in choosing what public mode to use for governance purposes. The court system is not unfamiliar with the law of trusts, but we need pause before scaling up several million times a concept applicable to a miniscule portion of the population and GNP to control over the entire publicly traded corporate sector. Other possibilities include explicit new laws with enforcement authority in the S.E.C., the Pension and Welfare Benefits Agency of the Department of Labor, or even a new agency. A strong President could take the position that adequate authority already exists under the laws regulating the pension system, mutual funds and bank trusts. We really do not know what is the ideal equilibrium of the creative tension between management and ownership. There should be no reluctance to progress gradually. In the U.K. the Department of Trade and Industry in the voice of Mrs. Beckett has nudged the institutional shareholders. Whether institutions vote or not is only one indication of sensitivity to ownership responsibilities. It remains to be seen whether there will be a substantive response.

The bottom line is that government action will be necessary to correct the market dysfunction caused by failure to enforce existing laws. So long as conflict of interest is tolerated, the burden of proving it does not damage the beneficiaries if appropriately placed with the trustee. There need be a free market place in which those who would do what is in the public interest are free maybe even encouraged - to do so without unacceptable commercial cost.

ENDNOTES

- [i] James Willard Hurst, *The Legitimacy of the Business Corporation in the Law of the United States 1780-1970*, U.Va.Press 1970, p. 88.
- [ii] Jeff Gates, *The Ownership Solution Toward a Shared Capitalism for the 21st Century*, Addison Wesley (1998), p. 35. Senator Russell Long, Chairman of the Senate Finance Committee at the time, assured me that these huge accumulations of capital [pension funds] were neither foreseen nor intended.[iii] Accountability must be clear and simple. There cannot be effective accountability to different classes of shareholder. The nature of pension fund beneficiaries as spelled out below most nearly approximates that of society as a whole. There can no question of running corporations for the short term benefit of arbitrageurs.
- [iv] Milton Friedman, *Capitalism & Freedom*, (University of Chicago Press, 1962), p. 133.
- [v] Jeffrey Goldberg, *Big Tobacco Won't Quit*, *The New York Times* magazine, June 21, 1998, p. 36. et seq.[vi] *Big Tobacco Wins One*, *The Economist*. June 20,1998, p. 32.
- [vii] *Nicotine Fix*, Common Cause Corporate Welfare Project *The Hidden Story of Soft Money, Corporate Welfare and the 1997 Budget & Tax Deal*, 1997, p. 30,31.[viii] Steve Campbell, *Washington Watch*, *Maine Sunday Telegram*, 6/21/98.
- [ix] Goldberg, op.cit.supra.
- [x] Jeffrey Taylor and Phil Kuntz, *Despite Polls, GOP Doesn't Fear Voted Heat on Tobacco*, *Wall Street Journal*, 6/25/98, p. A24.[xi] Goldberg, op.cit.supra.
- [xii] Richard Kluger, *Ashes to Ashes America's Hundred-Year War, the Public Health, and the Unabashed Triumph of Philip Morris*, (Knopf, 1996), p. 618.[xiii] The commitment may be minimal but the dollars and sense impact on the beneficiaries may be very large. Former New Jersey pension fund Chief Investment Officer Roland Machold estimated the costs of South African Divestiture at over one half a billion dollars.
- [xiv] Honorable Richard Blumenthal, Attorney General of the State of Connecticut, speaking at the 25th Anniversary of IRRC in Washington D.C., Spring 1997 (Internet)
- [xv] *Bellotti vs. Bank of Boston, Buckley, and so forth*.
- [xvi] Korten, op.cit.supra.
- [xvii] Robert A.G. Monks, *The Emperor's Nightingale*, (1998), p. 172[xviii] David Korten, *The Responsibility of Business to the Whole*, posted on the Internet, 6/19/98 - To ask the corporation to be responsible in some way to a broader set of stakeholders for meeting a variety of often vague and fragmented standards is to deny its nature as an institution designed to pursue a single clearly defined objective for a single interest constituency. It essentially means asking the corporate CEO to be responsible for making value choices on behalf of the corporation's shareholders, customers, and the society beyond profit maximization. Even if the law and the corporate board were to grant a CEO such discretion, what reason do we have to expect she will exercise it to the larger benefit of larger society. To whom and through what mechanisms is a corporate CEO accountable for the exercise of this discretion?[xviii]
- [xix] Jacques Bughin and Thomas E. Copeland, *The Virtuous Cycle of Shareholder Value Creation*, *The McKinsey Quarterly*, 1997 Number 2, 156,167.
- [xx] An outstanding exception in the United Kingdom is the leadership of Hermes CEO Alastair Ross-Goobey in successfully challenging the excessive length of rolling contracts.[xxi] SWIB = State of Wisconsin Investment Board
- [xxii] Performance can be quantified with reference to the industrial average as a whole or particular industry sub segments.
- [xxiii] How bad is bad? This will be impossible to answer to everyone's satisfaction, but it might be useful to think of total return to shareholders over several periods of time The *Wall Street Journal* does an annual edition showing returns over 1, 3, 5 and 10 years and say that drastic underperformance is assumed to be the bottom decile or even quintile.[xxiv] I am relying on the fact that institutional investors in the U.S. (top 100 companies) and U.K. own collectively over 60% of the total outstanding stock. There are public records as to who are these owners; there are competitive proxy advisory services that allow for cost / effective decisions on ownership alternatives. The important new ground is to place on each institution the obligation of working with their fellow shareholders in drastic situations. This happens often, naturally, in both the U.S. and the U.K.

[xxv] In demonstrating how conduct was in aid of beneficiaries' interests, it will be essential when appropriate to explain the other business relationships with the focus companies and how those commercial interests were effectively subordinated.[xxvi] Before concluding that this is unfair and places too great a burden, one should understand that money managers and consultants are among the most highly paid classes of worker in the world and that includes movie stars, football players and talk show hosts. You should see a rather splendid film WAG THE DOG, if for no other reason than to appreciate its Beverly Hills location which is the \$52 million house of Wilshire Associates principal Dennis Tito. Ned Johnson, the inheritor and builder of Fidelity, is thought to be worth in excess of \$5 billion. If you wonder why institutional investors have failed so utterly in their indispensable role as monitors of corporate conduct where managers have conflicting interests quintessentially in the area of setting their own pay it is well to remember that level of compensation is really not a subject that lies well in their mouths.