

## **MAPPING THE GLOBAL CORPORATION - Governing the Multinational Enterprise**

### **The Emergence of the Global Shareowner®**

**Robert A.G. Monks, LENS**  
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Shareowners are the only one of a corporation's constituencies that have the legitimate power to control its destiny. They profit to the extent there is surplus after all commitments are satisfied. Shareowners 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 other corporate constituencies prefer their own priorities to long term value maximization, it is important to keep in mind that only the shareowners are entitled to "give away" corporate property. The fragmented nature of shareowning 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 shareowner involvement has been largely anecdotal. James Willard Hurst, the foremost legal historian, characterized the situation as of 1970 in these words: as "...the general failure of shareholding to supply the steady surveillance by which stockholders were supposed to legitimate the power wielded in business corporations."

#### **Global Shareowners**

This conclusion needs re examination in light of the unanticipated emergence during the last quarter century of "Global Shareowners", one component of the modern institutional investors who hold more than 60% of the outstanding stock in the largest U.S. and U.K. companies and are increasingly the largest shareholders in public companies throughout the world. When I refer to shareholders or Global Shareowners, I take the public and private pension funds to be an appropriate proxy for the whole class of institutional owners. [Slides 2, 3, 4, 5, 6]

These Global Shareowners have characteristics that importantly bear on discharge of their "legendary function" of monitoring. The Global Shareowners are:

- Universal in the sense of owning all companies with shares traded on stock exchanges in all industries;
- Long term in holding period (indeed, the pattern of indexation suggests virtually permanent ownership); [Slide 7]
- Global in outlook, with increasingly similar expectations for financial performance and reporting in all countries and the ability to require consistent conduct;
- 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 lawmaker.

#### **History of the Global Shareowner**

The Global Shareowner is in the process of being recognized and defined. While the pattern of foreign investment has been common in the West since the 17th century, the beginnings of a class of investors with world perspective can be thought to have started with the creation of the modern pension system in the United States (Employee Retirement Income Security Act of 1974 ["ERISA"]). This statute created an institutional framework providing sufficient assurance on questions of the scope of investment authority, custody, delegation and liability to permit the development of a global investment culture.

Following the second World War, American corporations spread their operations around the world. The Global Shareowner followed in embryonic form as these corporations were obligated to make pension arrangements for workers in different countries. One of the elementary principles of pension investing is the desirability of matching liabilities and assets. Thus, when General Motors accrued pension liabilities to its Opel workers in Germany, there was strong reason to finance the pension promises with obligations designated in Deutsche Mark. The pension funds of multi national corporations and institutions were the earliest global investors. Perhaps the most successful early exemplar was the pension fund of The World Bank, which under its legendary Chief Investment Officer, Hilda Ochoa, was not infrequently ranked at the very top of the list of competitive performers.

This success led to imitation. During the second half of the twentieth century, several institutional developments critical to the evolution of the modern Global Shareowner took place. Currency and investment restrictions were relaxed and then abandoned by the principal industrial countries; brokerage practices and costs became more efficient and less costly; global custody arrangements (no mean question when dealing with "bearer" securities) matured; the accounting and legal professions of various countries "converged" towards mutually understandable and compatible standards; and international organizations - in particular the OECD - began the discussion of core international investment "rights" based on the principle that all countries would treat investors, domestic and foreign, the same. At the same time, the burgeoning "mutual fund" business began to develop country specific funds, which would permit investors to enjoy the benefits of diversification once they had decided to allocate assets to a particular country. The spectacular success of The Japan Fund, selling at a premium over market, encouraged many imitators.

What gave pension funds their special characteristics as the Global Shareowner is attributable in substantial part to a new industry of consultants, the Frank Russell companies of Tacoma, Washington, preeminent among them. The structure of ERISA placed a premium on trustees' availing themselves of expert advice. An entire industry of consultants, backed up by the academic work of many of the most highly regarded economists, brought a new and higher level of sophistication to the investment process. This sharpened focus illumined differences between general investment objectives and those suitable for "defined benefit" pension plans. Concepts that were too general for the investing world at large were very useful when applied to pension funds. In particular, mathematical tools were developed to evaluate risk and to demonstrate how diversification among economies lowered the risk of the portfolio itself. Investing in foreign countries became, therefore, a permanent part of the discipline of the pension trustees - not because of any particular appeal of any particular country, but because the process of diversification lowered the risk level of the portfolio as a whole.

We have earlier described the particular characteristics of these new Global Shareowners. While the law makes no distinction between the different kinds of shareholder, their relative size, both in assets and in number of participants, argues strongly that it is the pension beneficiaries for whose benefit managers run the enterprise. By formally identifying a coherent object for management duty, we begin to make some of the fiduciary relationships - the obligation of owners to beneficiaries, for example - susceptible of articulation and meaningful enforcement.

The emergence of Global Shareowners, therefore, has been a factor in the evolution of the nature of the multi-national corporation; it now has a governance structure involving informed and effective owners.

### **Owner's Responsibilities**

Much has been written about the difficulties that 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 Global Shareowners to expose

themselves to the risks of activism, and, not least, of the utter lack of qualification that the current Global Shareowners 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 -

Before we go further, we must repeat the reason why we believe an obligation is necessary. It is because the good working of the market-based system demands it for economic, social, and political reasons. The economic reason is that there needs to be a mechanism for controlling boards that do not work well so as to prevent unnecessary waste of resources; the social reason is that listed companies are a crucial and integral part of the fabric of a modern society and their success reduces alienation; the political reason is that the limited liability company has achieved its far-sighted originators' aims beyond their wildest dreams, of producing concentrations of power and resources, and that those who exercise these powers must be effectively accountable for the way they do so. The power and influence of the leaders of companies in domestic politics - and indeed internationally - are considerable. [Slide 8]

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". He goes on to require that this value maximization must be accomplished "within the rules".

### **Corporate Power**

But what are the Global Shareowners 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.

There are many public policy institutions outside of the corporation, which can have important influence on its impact on society. This is well articulated in a recent article in the Daily Telegraph:

· At the core of the debate is the idea that companies are accountable not just formally to their owners but also in less well-defined ways to a group of wider key stakeholders for their actions. · This notion has been helped along by the rise in consumer activism as shown in the GM food controversy and, before that, by the Shell/Greenpeace dispute. At the same time the success of companies that proclaim their concern for the community in areas in which they operate, like the Body Shop, has suggested that there is widespread public support for the trend.... · Today, the idea that a business exists only to serve its shareholders is not tenable. A company is judged not just on its balance sheet but to a growing extent on its corporate character. Does it serve the community in which it operates. Are its products ecologically sound? Does it pollute the environment? Does it do business with undemocratic regimes?

Business has the power to dominate outside regulators - governmental and non-governmental - so the ultimate feasible restraint is from within the corporation itself. Shell was forced to dispose of its Brent Spar drilling platform in a manner that history records as being wrong from an environmental point of view by a customer boycott, but this happening seems anecdotal rather than a precursor of effective and sustained corporate monitoring through public opinion.

There is no constituency other than the shareholder/owners who combine the motive, the independence and the power to articulate limits and to monitor and enforce compliance. [Slide 9]

### **State Action**

A response by shareholders requiring minimal commitment is divestment. The New York State Common Fund has stopped new purchases and cut its tobacco holdings to 0.5% 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 The Employee Retirement Income Security Act of 1974 (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 lawmakers 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 of 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."

Blumenthal poses a conundrum for the Global Shareowners. 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 judgements that take into account the global economy. Global Shareowners with permanent and universal holdings have no interest in condoning lower standards in different countries. 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. (e.g. the pollution standards in Eastern Europe) The Global Shareowners 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 Constitution**

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 more or less 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. 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 the computation and allocation of costs and benefits 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.

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 , 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 Global Shareowners.

## **Shareowner Value and Corporate Governance**

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." [Slide 10]

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.

The value and importance of shareholder activists has become recognized on a global basis:

"The priority in Europe, as many people in Europe have recognized, has to be on developing an appropriate domestic growth strategy. That means restructuring companies, allowing empowered shareholders to do the work of restructuring. It was these kinds of changes from the bottom up that I think contributed, along with deficit reduction, to the prosperity that we're enjoying in the United States." (Emphasis added) U.S. Treasury Secretary Lawrence Summers on CNBC, July 7, 1999

### **Active Investors**

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 Global Shareowners 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.

### **Conflict of Interest**

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 that was publicly identified with a private pension plan or one of its money managers. [Slide 11] 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 - 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.

### **The Problem of Proof [Slides 12, 13, 14]**

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 bedrock 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.

Positive Change is possible within the scope of existing laws.

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 has nudged the institutional shareholders. Whether institutions vote or not is only one indication of sensitivity to ownership responsibilities. Enforcement of the existing trust laws will encourage a spacious conception of ownership making corporations more sensitive global citizens. [Slide 15]

### **ENDNOTES**