

**Europe's Enterprise Strategy
Summit**
November 4th – 5th, 2001, London

Today, I want to take you on a bit of a trip. It's a visual trip. There's been a lot of talk about shareholder activism of various kinds, and the importance of putting it into context. The context has been provided by the title of this conference – *New Enterprise Agenda*. To truly understand shareholder activism, we must first identify the shareholders and also identify what can be done to encourage greater activism and shareholder accountability. I will argue that it is the responsibility of the government; much in the way the UK is doing with implementing the Myners report, to improve existing law which encourages activism in theory but makes it virtually impossible for institutional shareholders to act.

The first thing that you have to do when you have a trust is to understand that you have to administer the trust for the interest of somebody, and I'm going to talk about who this somebody is. I'm going to explore the entire universe of institutional investors, who are the trustees, many of whom are present at this conference, but more conspicuously, many of whom are not here. And then I'm going to talk about beneficial laws, government failure, and finally a few companies who I think are doing, or are beginning to do, things that are worth our support. In all of these themes I will be bringing you some good news and some bad news.

When you hear that it is the legal obligation of fiduciaries to run a corporation for the benefit of the shareholders, why did no one ever stop to think that there are all kinds of different people called shareholders? And they have very, very different interests. When the identity of the shareholders is vague, our efforts to increase trustee accountability to shareholders is blunted because we can't specifically identify for whom the trust exists and thereby create a set of standards that need to be enforced.

I thought of a tree. It's sacred to the Hindus, it means life. [SLIDE #1] If you look at the tree as a representation of shareholders, at the top are the arbitrageurs. They own the stock. Do we run the company for the benefit of the arbs? They own the stock for ten seconds, ten micro-seconds. Program managers -- the computer -- decide what stocks they own. Do we run the corporation for them? Sometimes they're in and out of stocks in a week, in a month, in a year. Mutual funds, they have stock ownership that relates to the tax problems of their beneficiaries. You probably are familiar with those if you just paid your taxes. Bank trustees -- they're a little more conservative, and they hold stock for a longer time. Insurance companies have to collateralize long-term liability. Pension funds. And then finally of course, the root is index funds. It means for many, owning a lot of stock forever. Who is the shareholder? The interests of the arbitrageur, the first group, are not at all the interests of the index fund holder. So, if you are going to have meaningful content to the notion of a fiduciary responsibility, you have to understand who is the person for whom you are running it. And I suggest that the defined benefit plan holder is the appropriate shareholder.

Pension fund beneficiaries typically have eighteen years to go before retirement and represent a huge percentage of the total population. These plan participants interested in retirement in the years ahead want to retire into a clean, safe and civil world. So, you can begin to see that you can define the scope of the obligation you owe as a trustee to the defined benefit pension plan holder.

Turning from the beneficiary of the trust, it is important to consider the extraordinary expansion in the last fifty years in the world of institutional investment. The size of the total outstanding equity in the U.S. in 1999, was almost \$19 trillion with institutional owners holding \$9 trillion and representing approximately fifty percent. [SLIDE #2] I hope that you have all had access to my New Global Investors, which describes this development in detail.

An entirely new world has been created. We used to have a world of business. We now have a business world and a world of ownership of business. And the world of ownership of business is much more profitable than the world of business. This is one of the problems. Managing money and providing ancillary services is probably the most profitable business in the history of the world. This has created a good news/bad news situation -- creating a lot of revenue with which good things can be done, but making it very difficult to change things because so many people have such a large vested interest in keeping things the way they are. Institutional holders in the United States alone hold \$9 trillion in assets. In the UK the institutions own a larger percentage of publicly held company stock than in any other country in the world. Only long-term shareholders have the perspective and the interest to assure congruency of ownership and societal values.

There is good news. According to Chancellor Gordon Brown, UK fiduciaries who fail to take an activist stance because of a wider business interest would be illegitimately subordinating the interest of their clients. In other words, if the trustee fails to be activist because of fear of scaring off future clients, the trustee can be held liable for not acting in the best interests of the beneficiaries. Brown's initiatives may well be the beginning of something being done about this problem in the rest of the Anglophone world.

Paul Myners' report (which, of course, is the base of the Chancellor's recommendations) also says, "Just because you do good for other people doesn't mean you shouldn't do good." Makes sense to me. Let me go back to the private pension funds. This is by far the largest category of institutional owners. This is the private company pension fund, like Shell, BP, British Tobacco [SLIDE #3]. If you look at this slide, on the right you will see what is supposed to be the Golden Rule, and it doesn't come from the New Testament, it comes straight from self-interest. It is the management of company "X" saying "Our pension fund will treat your management the way your pension fund treats our management." Now it's worth walking down through what looks like a wiring diagram there. And the management of company "X" appoints the trustee of the employee benefits plan. They could have appointed some bank to be the trustee. Now we are talking in the American context of about an approximately \$5 trillion pension fund. Well, by and large if you picked up half percent of the management fee, that's twenty-five billion dollars. Then add on to that the control over the brokerage commission, which is another half of one percent, or twenty five billion dollars. This is an immensely profitable business -- perhaps more in the City than in the United States.

So, the trustee of the employee benefit plan hires investment managers. The trustees are in a very difficult position. The trustee, even when they are paid at all, is paid very little and they are dealing with people who are rich beyond belief as a result of decisions that they made. It is a situation that would try an angel. The investment managers of the equity portfolio own stock in company "Y" and company "Z". And what I am urging is that the investment manager be an activist about company "Y" and company "Z". The investment manager who is getting some portion of this fifty billion dollars from company "X" is faced with the golden rule problem. If he is active, he will make the trustees of company "Y" and company "Z" pension fund very upset with him. They may retaliate with company "X" or they may even worse retaliate by not having the investment manager on the shortlist of people who can get the next pension fund.

Institutional money management is one of the biggest industries in the world. The amount of money is simply staggering in terms of its impact on whole communities. The profit margins are the highest in the world and yet it is subject to this circular system in which so much money is involved that people are virtually inhibited from doing their plain legal duty.

Now, the foundations and the universities. I have been appalled at meetings like this that the financial authorities from the great universities generally don't attend. I have been appalled in the case of universities that I have personally been affiliated with, that they simply will not undertake responsibility of owners of the securities in their portfolios, even as they offer world famous tuition

in ethics and philosophy. The same thing is true of the great foundations. These are people who our society considers leaders. And yet we have tolerated a system in which they don't act and they do not require their money managers to act. The problem is outlined in a letter that I received [SLIDES #4 and #5] from one of my closest personal friends, a former chief executive officer of a major international fiduciary bank. His position was that he could not be an activist because his customers didn't like it. He is the most honorable man I know. And when he made his point, I had great empathy with him. He was someone who wanted to do the right thing, would do the right thing, but the system prevented him from doing the right thing. Because if he was the activist his customers would go to another bank. And so long as you have uneven law enforcement, people like him, who absolutely want to do the right thing, can't do it, because to do so is to create risk for the people who work for them. And so this is a place where we need the law to be enforced.

The law is very clear. The trustees are obligated to run the trust for the benefit of the beneficiaries who, I'm suggesting to you, are the equivalent of the long-term pension plan owners. Universities are ignoring the law. So are foundations. So are private corporations. And the government created this problem. It used to be when you talked about owners of companies you were talking about a roster of rich people and a faceless public. Nowadays, you have institutions, largely pension funds. And the institutions own so much of the stock that the opportunity for flesh and blood people to have any real role is gone. The institution was created as an unintended consequence of retirement and savings policy, and because the government won't enforce the law, institutions don't have to follow it.

Respective ownership involvement in corporate governance will not be possible until and unless the government effectively corrects the problem that it has created. Even the most doctrinaire lover of small government would have to agree that you want the government to undo the mess that it has made. So, I make no apology in saying that the government has to do something here. They've got to cut the roadblock. They've either got to enforce this law that says that trustees have got to be active or they've got to provide some other way for corporate governance to operate. All of the fiduciary laws -- those covering investment trusts, those covering charities, those covering pension funds, those covering banks trusts -- must be the same. It has to be the same law. The government in the UK has now said: "Once and for all we think it is important to have an empowered owner." This must be effectively implemented and enforced.

Let me go back to the values of the Beneficiary. Now I mentioned to you before the reasons why the pensioner is the right beneficiary of all these trusts. Long term. The person for whom a trustee runs a corporation is long term. Let there be no doubt about that. They run it for people who are not inanimate objects, but instead human beings, who want to retire into a civil, sane, clean society. (SLIDE #6 – Optimal values) They want companies to follow policies that will make it a clean world that will make it a civil society. And so, you want never again to let anybody be confused about who is the shareholder of a corporation. We have a law with all kinds of wonderful provisions that nobody can enforce. The theoretical ability of shareholders to run a corporation has been impeded by often well-intended laws but the result of which has been to bring us to a total stop. We are now in a position to move on.

It will require much experience, many mistakes, patience and perseverance for a detailed ownership agenda to be articulated. But we can begin – all institutions should require that the companies in which they invest adopt the following policies –

- Disclose publicly how their functioning impacts society (SLIDE #7)
- Exercise restraint in influencing and financing government (SLIDE #8)
- Obey the law (SLIDE #9)

If these policies are faithfully observed, the public can have confidence that it lives in a country with laws that legitimately express the will of the people and it can be content simply to require corporations to behave lawfully.