Equity culture at risk -
The threat to Anglo-American Prosperity
By Robert Monks

Standfirst:
Efforts to restore public trust in the governance of corporations are hampered by abuse of power at board level and the neglected rights of shareholders.

Prosperity in the Anglo-American world since World War II has in large measure been due to the success of the equity culture. Those willing to take ownership risk in exchange for the ownership rewards of investment in public companies have achieved significantly higher rates of return than investors in debt securities. Looking forward to 2025, the respected American statistician Roger Ibbotson forecasts net returns per annum (after inflation and taxes) of 8.5 per cent on large company stocks and 2.3 per cent per annum for government bonds.

Savers around the world search for a mode of investment through which they can earn the highest return at acceptable risk. Common stock of publicly traded companies provides investors with a particularly attractive blend of reward and risk, *but only so long as they feel that the market is honest.* Governance is about providing this assurance. Only if investors are convinced that (1) they are making decisions to buy based on reliable information and (2) that management is running the enterprise for their benefit will the market place value stocks attractively. It is the element of trust on which the world's wealth depends.

The 'triumph' of excess

The United States is currently suffering from the aftermath of hubris. All the triumphalism of the 1990s – GAAP as the supreme accounting language; governance as the global preference; competitive performance as the wonder of the world – has turned to ashes as concern spreads that trust has been destroyed. The concern is not just with renegade companies such as Enron, Global Crossing and Tyco. The 'best' companies in America used accounting practices that, with hindsight, appear dubious at best and criminal at worst.

Policymakers in the US are still desperately trying to understand what has to be done to restore confidence. While the SEC has unveiled a range of initiatives to demonstrate that its legendary competence survives, the real work has been done by the Attorneys General of several states, notably New York and Connecticut. Fear remains widespread that the 'golden goose' has been killed.

History will look back on the last decade of executive compensation in the United States as an atrocity. The levels of pay exceeded any historical precedent, bore little comparison with compensation in other countries, and – most importantly – failed to have any correlation with the creation of value for shareholders.

The most important component of compensation was the grant of options that, according to the accounting rules after 1994, did not have to be accounted for as an expense by the issuing company. Typically, the top five executives in a company held 75 per cent of the total options granted; the ratio of option shares to the total outstanding rose in the 1990s from two to 12 per cent. This must be the greatest 'peaceful' transfer of wealth in recorded history.

The excesses went beyond mere numbers. Consider what the board of IBM did for its retiring CEO, Louis Gerstner. Gerstner is considered by those who supervised him at McKinsey and those who serve on his IBM board as the 'very best'. Following a highly successful ten year career at IBM during which he received several hundreds of millions of dollars, he was awarded 125,000 shares of restricted stock – worth in December 2001 approximately $15m – as a 'going away present'. In addition, he is to be paid for any consulting work he actually performs after retirement at a daily rate based on his CEO salary; there is no recitation of what his duties are to be; there is no indication of a level of commitment required from him, beyond non-competition. For the first ten years, *plus an additional 10 years (Gerstner at the end of this contract will be 80 years old!)* he will receive "access to Company aircraft, cars, office, apartment, and to financial planning and home security services and he will be reimbursed for club expenses for Company business. He will also be treated as a retired employee of IBM, including for purposes of pension, retiree medical benefit coverage for him and his spouse, etc."

On top of this there are the insurance and deferred compensation arrangements; the infamous split dollar (that actually may have been made illegal in the July reforms); and the ingenious estate planning devices that assure the corporate largesse will pass to future generations with minimal tax impact. The amount of corporate time and talent necessary to negotiate and administer the arrangements with the CEO is such as almost to justify a separate department. When one considers that Manhattan apartments run up to $20m for a self-respecting CEO and aircraft can cost up to $90m, the present value of this life-time *douceur* must be very large, indeed.

GE's Jack Welch, meanwhile, everyone's candidate for CEO of the century, stimulated further public disclosure of corporate compensation excesses through the actions of his abandoned second (lawyer) wife in divorce proceedings.

Creatures of the CEO

The lack of shame, even at the top level in American executive compensation, is the clearest possible indicator of governance failure. At some point in the 1990s, corporations became the creatures of the CEO. Alignment of corporate direction with shareholder interests was coincidental and fleeting. All of the disturbing elements of excessive management power were manifest: Orwellian language to mischaracterise what was always a one-way street towards higher compensation for executives; the use of corporate resources to lobby and overwhelm public agencies. Bear in mind that the Business Roundtable (The CEOs' effective trade organisation) overturned the accounting regulators up to the point of commanding a vote in the United States Senate that option grants not be recorded as an expense on the company's income statement.

Here is how the 'option machine' worked. First, the shareholders would dutifully authorise the issuance of a large number of shares on conditions to be approved by the board. There was little warning of what was to come, although proxy advisory firms like Institutional Shareholder Services (ISS) recommended voting against dilution levels above a particular percentage. Then, option plans were adopted – of which, as we have noted, the overwhelming beneficiaries were the CEOs. With market prices rising generally during the last five years of the 1990s, options were usually 'in the money', and executives were anxious to exercise them and lock in the profits. Top executives were often given free loans to exercise their options meaning that they were able to buy the underlying stock *without putting up any money.* Companies usually had in effect a general programme for the repurchase of stock so that when the shares were 'sold' in this way – 'off market' - there was no adverse impact on the price.

The pattern of corporate overpowering of government regulators – out manning is more apposite – is apparent in the reporting requirements for such 'insider' sales. We are told that CEO Ken Lay of Enron 'borrowed' money from the corporation every day for several weeks, which was repaid by selling his preferred shares back to the company. For reasons that will intrigue legal historians, he did not have to report these 'sales' under the usual insider requirements; they were only made public at the end of the year. Finally, the machine had provision for its eternal life – through formulae (remember that CEOs in another guise continue to insist that options cannot be valued) a number of the option shares were converted into new options at the current market value – a process known as 'reloading' – which, in a rising market, guaranteed an infinity of wealth without any reference to correlative benefits to the company or its shareholders.

It gets worse. There is no instance that typifies the 'appropriation of corporate value' by top officers more dramatically than the scam of Sprint's top officers in 1999. Sprint's option plan contained the usual 'change of control' provisions, by which executives would be protected in the event that board membership or stock ownership changed so materially as literally to alter the conditions of their employment. In the abstract, this seems an admirable provision. The devil is in the details. Shortly prior to the announcement of a proposed acquisition, which most of the financial community realised would *not* be consummated because of anti-trust problems, the Sprint board without public disclosure changed the definition of 'change of control' – henceforth a change of control of Sprint would be deemed to occur upon a shareholder vote to approve a sale or merger of Sprint *even if that sale or merger never actually took place. Mirabile dictu!* Guess what happened? Sprint executives extracted $1.2bn in newly vested options immediately after the vote. Many of the vested executives quickly left the company and business continued – exactly as before the 'transactions'. The merger, of course, did not take place.

So where were the boards?

Where was the board of directors while company executives were transferring to themselves 10 per cent of the entire value of the outstanding stock on public exchanges?

The concept of a board of directors is so beguiling as to have inhibited careful analysis of what it does, and, more importantly, what it can do in times of extreme difficulty. Part of the problem stems from language confusion. By 'board of directors' the English mean a group presided over by a Chairman, having no other relationship to the corporation, comprised almost equally of senior executives and by so-called 'non-executive' members devoting perhaps ten to fifteen days a year. In the United States, the dominant practice is for the chief executive to function also as chairman of a board comprised entirely of outsiders. It is plain that one can expect very different conduct from a board having its own direction and including the individuals most knowledgeable about the business than from one in which all knowledge and direction flow from a single individual. Whether the time commitment for either board bears a reasonable relationship to what would be required fully to discharge the responsibilities of the position is an unanswered question. It is surprising that in all of the literature having to do with directors there is lacking a systematic analysis of the number of hours and the quality of expertise needed to fulfil the statutory, charter and by-law responsibilities of a board. My own experience would suggest that the disparity between the assigned responsibilities and the committed energies is so great as to account for much of the bewilderment about board dysfunction in times of difficulty. Boards work adequately so long as the demands are predictable and slender; it is this orderly process with which so much of the literature is concerned.

In the UK much board practice is dictated by a shared culture beyond the requirements of law. In the US there is no shared culture, so the law is the ultimate determinant of board functioning. It

will be apparent that no generalised conclusions about board practice in the US and UK can do more than suggest a beginning to focused inquiry.

In America, the question must be asked – is the commitment to a board so marginal as to require the conclusion that it is a convenient fiction? One must consider the dynamics of a self-selecting group whose agenda, information, procedures and meetings are controlled by the individual who is primarily responsible for the functioning which the board is supposed to monitor. Some commentators have concluded that the board is essentially another division of the corporation, to be 'run' like sales or finance or administration by the CEO. It certainly is convenient for CEOs to be able to refer publicly to their accountability to a board; board members are unlikely to question a generous view of their own importance; and government is not comfortable intervening where private resolution seems acceptable.

The lessons of Enron

Senator Carl Levin, as Chairman of the Permanent Subcommittee on Investigations has recently provided perhaps the most authentic view into the nature of boards at a hearing with the four most senior directors of recently bankrupt Enron. These individuals are the flower of America's director culture; they each had served for 17 years; they chaired the most important committees – executive, finance, compensation and audit; three had earned doctorates; all were paid a minimum of $350,000 per annum. They appeared voluntarily and at substantial personal inconvenience in order to articulate plainly and repeatedly that they were individually and as members of a board not responsible for the collapse of Enron or for the loss of investments, pensions and jobs.

Chairman Levin issued a formal report in which he concluded that blame lay at the door of the board. One was reminded of Peter Drucker's observation that "whenever an institution malfunctions as consistently as board of directors have in nearly every major fiasco of the last forty or fifty years it is futile to blame men. It is the institution that malfunctions." Is the experience of the Enron directors confirming Peter Drucker's conclusion - you can count on the board except when it is really needed?

In hindsight some caution is advisable. Seventeen years of service on a board raises the concern that the monitors are becoming too much part of what they are supposed independently to hold to account. The compensation is so much in excess of the national norms as to raise the ugly question – what is being bought? Age is not, in itself, determinative of capacity, but any watcher of the Hearings could conclude that this was a board that did not subject itself to any effective self-evaluation. Although the Hearings and Report do not even raise the issue, it is immediately apparent that this board suffered grievously from the absence of an independent chairman. Nobody was responsible for making sure that it covered all the necessary areas. Responsibility repeatedly fell between the cracks. No one was responsible, for example, for CEO Lay's daily pattern of borrowing and repaying of millions of dollars with 'sales' of company stock. Everyone had their own area of responsibility; they existed in tightly defined areas. There was a veritable chorus of "we were misled by management"; "we were misled by the auditors"; "we instituted systems of controls that we were entitled to believe would do the job"; "Reality cannot be laid at our door."

What is striking is that all these experienced and respected men confidently approved very important transactions in full knowledge that the accounting treatment *did not convey an accurate picture of the economic implications of the matter.* It was known that the Audit firm which certified that the transactions complied with Generally Accepted Accounting Principles had, in another guise, received very large fees to contrive the transaction. But, at the end of the day, nobody appeared worried that they were approving financial statements that they *knew* did not present a full and fair account of the company's financial condition. At some point, the decision was made that Enron would exist according to a tortured accounting reckoning and that meaningful financial information would not be used. This critical mode was adopted by a top management with huge

incentives for short-term stock price increases and was uncritically accepted by the board. Without leadership, the board became an institution processing information so as to ratify management's – often self-serving – functioning. When the management decided to set up an 'independent' off balance sheet entity of which the Chief Financial Officer was to act as principal to whom to sell corporate assets and debt, the board members, under repeated questioning, could not bring themselves to acknowledge that they had waived the corporation's conflict of interest policy. They insisted that all they had done was to accept the CEO's finding that the appointment would not adversely affect the corporation.

This level of detail is essential in beginning to understand the deficiencies of the American board. Individuals want to serve on boards. It is a prestigious and, for many, a lucrative assignment. The work is interesting and the sense of being 'one of the top people' is infectious. There is no incentive to be confrontational. There is a negative incentive to questioning the system itself. There is no holistic sense of responsibility. Perhaps the answer is simple – the American board simply is not designed to discharge the responsibilities which are placed on it.

The process by which directors are selected in both the US and the UK bears no resemblance to the accepted meaning of the word 'elected' which is used in the American statutes. The widespread use of words in an Orwellian mode and the rampant conflicting interests must raise questions about board integrity. How a 'self-selecting' organism can be thought of as having 'independent' members is a good place to begin reflection. Then we must acknowledge - as a practical matter, directors really do set their own pay. Similarly, 'independent' directors select the auditors whose principal responsibility is to monitor those in whose gift is their appointment. Why do we persist in such a confusing use of words? Why do we ignore these blatant conflicts of interest? Why do we pettifog so endlessly trying to refine definitions of 'independence' which everyone knows to be untrue? In America, the answer is quite clear. The concentration and application of so much power in unelected officials is contrary to the myth of a free democratic society that underlies the country's sense of legitimacy.

Concluding thoughts

In an address at the Stern School of Business in New York on March 26, 2002, Alan Greenspan, not for the first and one hopes not for the last time, gave the American people a clear and sensible analysis of an important and pressing problem. He was addressing the need to restore public trust in the governance of corporations in the aftermath of Enron and Global Crossing. He suggested that the basis for a reliable system of corporate governance is either "the current CEO-dominant paradigm" or the willingness of "large - primarily institutional – shareholders to exert far more control over corporate affairs than they appear to be willing to exercise." He chooses the 'benevolent despot' – "[I]t seems clear that, if the CEO chooses to govern in the interests of shareholders, he or she can, by example and through oversight, induce corporate colleagues and outside auditors to behave in ways that produce de facto governance that matches the de jure shareholder-led model."

And yet, so much of the governance corrosion of recent times can be traced to the abuse of power by Chief Executive Officers. Effective capitalism requires that corporate managements have wide executive powers *and incentives* to develop and execute strategies in the long-term interests of shareholders. To meet this requirement the wider interests of customers, suppliers, employees and the community must be met: shareholder profits are the residual after meeting these prior claims. Corporate governance, properly understood, is a process of effective accountability of managements to informed and active owners. At the heart of my concern for the state of Anglo-American shareholder capitalism is that chairmen/CEOs and their executive director (senior management) colleagues have at least six major inappropriate powers giving rise to serious conflicts of interest. These are that corporate managements:

choose their 'independent' non-executive colleagues;

choose the ‘independent’ auditors who are also usually consultants with consultancy services averaging several multiples of audit fees (shareholders automatically support board recommendations on these two matters which comprise ‘coerced ratification’ of what should be shareholder chosen monitors of corporate managements);
choose the remuneration consultants for the non-executive ‘independent’ remuneration committee (usually the company’s own appointed remuneration consultants with loyalty to its management);

exercise power over their own company’s pension fund trustees and their fund managers to take a non-activist corporate governance stance on other companies implicitly in return for similar reciprocal passivity;

have major powers of patronage also over most other fund managers seeking their pension fund business, who are frequently part of wider financial organisations wanting investment banking or insurance business; and

avoid allowing separate advice to non-executive directors on the merits of significant takeovers and mergers despite the frequent clash with shareholder interests.

The effective removal of all these inappropriate powers is thus the litmus test for any worthwhile reform of shareholder capitalism.

It has long been observed that no-one looks after other people's assets as well as they do their own. The need is to move from the rhetoric of giving primacy to longer-term shareholder value to making it a reality in a socially acceptable way commanding public trust. This requires the alignment of the interests of corporate managements and institutional intermediaries to those of individual and beneficial shareholders. The present widespread and serious conflicts of interest would never be tolerated in politics. They should no longer be tolerated in business where most of the retirement savings of America and Britain are subject to significant avoidable risk and damage. Indeed such is the current public and political mood in both countries that major changes are inevitable. The challenge is to ensure that the changes realistically address the main problems.

The existing law governing trustees and fiduciaries in America and Britain already explicitly requires that they act solely in the interests of their beneficiaries for the exclusive purpose of providing them with benefits. But this law has not been enforced in either country, nor have there been penalties for inaction. What is required is not so much new law as the enforcement of the existing law on pension fund trustees, life insurance company fiduciaries (in fact on their boards of directors) and, by implication, equally on the boards of mutual funds, unit and investment trusts. My clear preference is to enable owners to look after their own interests by removing the handicaps which presently prevent them. It is impossible for either owners, or their intermediaries, or self-regulation, or market forces to overcome the present serious systemic fault. An effective external catalyst is needed and that catalyst can only be government.

Every credible analyst of the desirable scope of government action - from Adam Smith and John Locke to Frederick Hayek and Milton Friedman - agrees that government must set standards and secure compliance to encourage action for the public good and discourage actions for public harm. Government involvement is now clearly needed in corporate governance to guarantee the nations' citizens the neglected rights of ownership of their major assets, stocks and shares. To this end we believe four modest but highly catalytic government actions are first necessary. What is needed is a clear and consistently enforced public policy. It must give all owners' representatives, the intermediary investment institutions and their fund managers, the clear fiduciary requirement to be active with respect to companies held in their portfolio accounts, and the confidence that they will not be placed at a competitive or reputational disadvantage with

their competitors by complying. Above all else, it must be unmistakable that both governments intend and are capable of enforcing the trustee and fiduciary laws for the 'sole' purpose and 'exclusive' benefit of their beneficiaries' interests - the greater part of the funded pensions of most citizens - in an even-handed way.

I propose as follows:

> Governments should affirm that creating an effective shareholder presence in all companies is in the national interest, that there should be no power without accountability and that this principle should be taken into account by all regulators, the Anti-Trust Department, the Takeover Panel, the competition authorities and stock exchanges. What shareholders are supposed to do is to assure the continuing functioning of an appropriate board of directors; they are not expected to manage the enterprise.
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> All pension fund trustees and other fiduciaries (insurance companies, mutual funds, etc.) holding shares must act solely in the long-term interests of their beneficiaries and for the exclusive purpose of providing them with benefits.
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> To give full effect to the first two proposals institutional shareholders should be made accountable for exercising their votes in an informed and sensible manner above some sensibly determined minimum holding (e.g. $15m/£10m). Votes are an asset (voting shares always have a market premium over non-voting ones). Accordingly, they should be used to further beneficiaries' interests on all occasions. In effect, the voting of all institutionally held shares would be virtually compulsory.
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> To complete and powerfully reinforce the other three proposals shareholders should have the exclusive right and obligation **to nominate** at least three non-executive directors per major quoted company. The appointment of a quota of a few shareholder nominated non-executive directors would still leave chairmen/CEOs and their colleagues to appoint the rest. As with non-executives now, the great majority of such independent shareholder directors should be chosen from the same pool of experienced businessmen and professionals as they are drawn from at present. Indeed, they would be unlikely to attract sufficient support from either individual orinstitutional shareholders if they were drawn from any other source. The crucial difference would be that the shareholder nominated directors would be quite free of *any* implied obligations. The record of all too many failed and damaged companies has shown that the appointment of independent non-executive directors - endorsed by *all* Anglo-American enquiries, commentators and the financial press - is far too important a matter to be left solely to executive directors who have conflicts of interest, and many of whom have abused the position. Nor would such shareholder nominated directors be a divisive presence. They would be concerned to show their colleagues that they also were primarily committed to the sustainable success of their company. The management appointed non-executives would be equally concerned to demonstrate that they too were independent in their conduct and judgments. This is one of the most necessary and overdue of all corporate governance reforms because it ensures, ***for the first time,*** that shareholders can participate effectively in the choice of a critical mass of truly independent non-executive directors. This is widely but falsely claimed to be the present reality by nearly all official enquiries and corporate managements. (It is routinely asserted that the majority of management appointed non-executive directors in both countries are 'independent'. This has not prevented the many evident corporate shortcomings and failures.) This proposal amounts to making a partial reality of what is presently but wrongly claimed to be the universal position, namely "…that shareholders elect the directors."

Robert Monks is widely seen as the leader of the 'shareholder activism' movement. He founded Institutional Shareholder Services, Inc. (ISS), now a successful corporate governance firm, and co-founded the LENS investment fund.

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QUOTE:
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