

**Universal Owner Conference
April 10th & 11th, 2006**

**The Center for the Study of
Fiduciary Capitalism Issues,
Saint Mary's College of California
Moraga, CA**

**Challenges for Fiduciary Capitalism – 2006
By
Robert A. G. Monks**

The concept of fiduciary capitalism is now established. It is beyond denial that institutions (subject to fiduciary discipline) own a majority of the publicly traded securities in corporations around the world. There is substantial evidence that constructive involvement by owners in the governance of corporations creates value.¹ Significant progress has been made to add environmental concerns to the activism agenda.²

There are today two fundamental challenges to the further progress of fiduciary ownership: the first is to insure the participation of the full spectrum of institutions in ownership initiatives; and the second is to insure enforcement of fiduciary obligations either by direct government action or through private litigants.

Shareholder activism has largely been the work of public pension funds – conspicuously those of the State of California. It was said at the beginning a quarter century ago and it can fairly be said today – without CALPERS, nothing. With the exception of a conspicuous breach of fiduciary focus, exemplified in the Safeway matter, CalPERS has managed to provide consistent sustained and inspired leadership. CalPERS administers the pension resources of government employees, the trustees are political appointees and white collar union officers. In efforts to disparage shareholder activism, its opponents are wont to comment: “Do you really want a bunch of union people running your money? None of those guys have ever met a payroll, etc.” It was inevitable that an incident like Safeway would occur giving substance to this mischaracterization. Several other public plans have at different times and to different degrees been usefully active: Connecticut, New York City, New York State, and Florida - CalSTERS comes to mind. Also, there has been increasing involvement by labor unions, especially under the leadership of Bill Patterson.

If one were to create a taxonomy of institutional investors across a span from left to right, approximating the terminology of contemporary politics, public pension plans and labor unions would be on the left. Next to them would be universities and foundations, then the huge spectrum of mutual funds, bank trusts, and finally private company pension funds subject to ERISA.

¹ See in particular Becht, Franks, Mayer and Rossi – Returns to Shareholder Activism: A Clinical Study, London Business School (February 2006)

² Trucost in London provides reliable estimates of effluents by individual corporations and, thus, a basis for shareholder involvement.

By and large each of these groups is crippled from activism by conflicts of interest, in many cases social, in others legal. Universities – exemplified by my own alma mater Harvard – simply decline to act, ignoring the ethical considerations they are teaching. Foundation trustees are part of the managerial elite and are loyal to their club if not their principles. On the right would be the private company pensions who have the most clear legal requirement to be involved and who have, as of this day, never done so. The challenge will be to secure the involvement of this whole spectrum, so that the “language of activism” can be understood unmistakably as being in aid of ownership values and not of any sectarian advantage.

This is not a modest challenge. I will share with you some examples of my own ongoing efforts in this regard. It is the custom at Harvard to make gifts on important anniversaries – indeed, it is the custom at Harvard to make gifts period. On the recent occasion of my Fiftieth Anniversary, I decided to make Harvard a real gift – a gift of what wisdom I had derived – rather than just coin. I duly made an appointment with the President and presented him with a lengthy letter {A very nice chap, Larry Summers, he said if it was all the same to me, he would just as soon have the money.}, which is available on my web site – <http://www.ragm.com> under the title To Harvard with Love, an extract from which follows:

“Harvard has become an “owner” of virtually all of those enterprises whose collective functioning impacts life on earth perhaps more than any other institutions. The question is the extent of Harvard’s responsibility as owner. What is Harvard doing now? Does she ensure optimum value? What should she do in the future?”

President³ Bok codified what I will call Harvard’s policy of “institutional deference” to the status quo:

One might well ask how far “beyond” the “ivory tower” President Bok ever ventured when the path was marked “investments”. Not far enough, in my view. Like his predecessor, Summers also appears to conclude that Harvard is free to decide unilaterally whether or not it will be accountable for the consequences of its investments. He has contented himself with “*Harvard is first and foremost a center of learning, not an institutional organ for advocacy on such a complex and controversial international conflict.*”

³ Derek C. Bok, after a splendid career as Dean of the Harvard Law School and President of Harvard College, will once again assume the Presidential mantle as of July 1, 2006. He is the quintessence of a fair minded expert.

Harvard has developed a very worldly competency to increase the asset value of her investments. Can one seriously object to her taking worldly responsibility for some of the consequences of her investments? After all, Harvard is one of the largest owners of public corporations; she is not a stranger to their impact on society.

Institutions cannot simply define problems as being external to their mission; at some place “the buck stops” and some institutions have to begin to accept responsibility. The alternative is a chaos where the most difficult problems are simply ignored by those best qualified to help, left to fester in the certainty that they will become toxic.

Harvard must face reality. Our great university exists not in a tower, but in the real world — where businesses have a costly impact.

I confess as President Reagan’s appointee to head the Department of Labor’s office in charge of the private pension system (“ERISA”) to a measure of frustration. My most distinguished successor – Olena Berg, formerly assistant Treasurer of the State of California – issued in 1994 a regulation codifying the obligations of ERISA trustee to be involved in the affairs of portfolio companies in order to protect and enhance value for plan participants. That notwithstanding, there has never been a recorded instance of an ERISA plan initiating ownership activism with portfolio companies. In the first instance, this is a failure of enforcement which I will discuss below at some length. It is also a cultural failure. It has been proved that activism adds value, what right do the trustees for America’s employees have to fail to take value adding steps?

One of the too little applauded accomplishments of former SEC Chairman William Donaldson is the requirement of public disclosure of votes by mutual funds. Already, there is gratifying confirmation that the need to account to your customers can prevail over the managers’ short term personal business interests. We finally have some leverage with which to include the huge mutual sector among responsible fiduciaries.

There have been one or two foundation leaders, conspicuously Stephen Viederman and Lance Lindblom, willing to lead. The fact that I can only elicit two names is evidence of the disgrace of foundation trusteeship. I use the word disgrace because of both moral and educational failures.

How could an intelligent person responsible for allocating resources to alleviate world problems refuse to confront and react to the extent these problems are caused by companies in his own portfolio. How could an educated person pretend that their foundation exists in a vacuum of its own description, that it can collect resources from whatever source and ignore the source's impact on the whole.

With the recent addition of “hedge” funds and high profile value investors, like Carl Icahn, to the activist ranks, our problem is not at all one of getting enough votes. It is a matter of getting the agenda right. The ultimate necessity for ownership involvement is to legitimate corporate power. Owners, roughly half of the population, uniquely are entitled to judge the appropriate balance between public and private interests, between societal and corporate responsibility for the externalized liabilities of business.

I have a challenge for each individual in this audience – it is a challenge that I am entitled to make as I, personally try and I fail, but I will not stop trying. I ask you to identify a single large corporation, a single foundation, a single mutual fund, a single university – make it your business to solicit key individuals in that institution with respect to their ownership obligation. Our cause is correct; we cannot forever be ignored; but we will be ignored until we can penetrate the comfort of those enjoying the fruits of the tree that they are poisoning. This can only be accomplished peer to peer. People who prefer their “club” to the public good will have to confront the reality of rejection by the rest of society.

There has been continual erosion of what tradition styles as “trustee behavior”. Law makers continue to “talk the talk” of trusteeship being something special, but the practice is increasingly otherwise. We should go back a few years in order to understand what has happened.

Henry J. Friendly, Chief Judge of the 2nd Circuit Court of Appeals reversed the opinion of a lower court permitting Lazard, the manager of an investment company subject to the 1940 Act, to “sell” its interest to another party. There is no clearer articulation of where we came from and where we are going than this paragraph from his 1971 opinion in Rosenfeld v. Black. “It is understandable that, under “the morals of the marketplace, Lazard should see no reason why, having selected a competent advisor willing to serve on the same terms Lazard had done, it should not perceive what the new incumbent was willing to pay for the opportunity. But equity imposes a higher standard. It is fitting to repeat Chief Judge Cardozo’s familiar words, ‘Many forms of conduct permissible in a workday world for those acting at arm’s length are forbidden to those bound by fiduciary ties.

Not honesty alone, but the punctilio of an honor the most sensitive is then the standard of behavior. As to this, there has developed a tradition that is unbending and inveterate' Meinhard v. Solomon."

The Anglo American legal system has long ingrained in its DNA a fundamental difference between commercial relationships and trust arrangements. Government, in writing statutes like those governing Investment Companies and Mutual Funds, used the familiar words and language of trust to characterize the standards of conduct applicable to various regulated parties. By using the language of trust, these statutes adopted the "unbending and inveterate" common law prohibition against assignment of the personal duty/responsibility of a trustee.

Law makers and judges knew the difference between trust conduct and business standards when it came to the federal statutes governing the conduct of what has become to be the majority shareholder of all U. S. public companies. The various characteristics of "trustee" that made a fiduciary majority something very different from ownership by human beings are being transformed utterly as the "trust" becomes a bauble of commerce. What was earlier a theoretical conflict of interest became a blatant situation of what was profitable for the manager was harmful to the beneficiaries of the trusts and vice versa. As was inevitable, management companies became subsidiaries of financial conglomerates with a whole range of interests, concerns and customers with interests not aligned with and occasionally opposed to those of fund beneficiaries.

This was not a predetermined result. There was nothing inevitable about the conflicting interests between fiduciary manager and beneficiary of even the gigantic trust system involved in retirement schemes and mutual funds. One of the largest pension funds outside of the United States is the British Telephone Pension System ("BTPS"). BTPS owns Hermes Investment Management Company, the investment advisor for the system. Not only are the annual profits of Hermes available as an off set for required payments to the pension scheme, but all increases in the value of the management company – in the event it would be held for sale or even if its market value as a private company would be recognized by the actuaries – are assets of the Pension System and further security for the beneficiaries. In very much the same way, the Vanguard Mutual Funds in the United States are administered by a wholly owned subsidiary. There is a very clear question - who owns the value of the management company – the shareholders of that company or the beneficiaries of the various trust funds?

The implications of Congress determining that this fiduciary function was a commercial asset could hardly have been imagined, but in many ways the history of the last thirty five years is the story of the enrichment of the intermediaries, of whom money managers are only the most conspicuous, and the impoverishment of the beneficiaries.

Jack Bogle, the founder of Vanguard and an astute (and, occasionally astringent) observer and commentator on mutual funds for all of the 55 years since he wrote a Senior Thesis at Princeton on the subject, has recently written of the dynamic unleashed by the loss of fiduciary control.

“So it is in the manager’s interest;

1. To build the largest possible amount of fund assets, because fees rise as assets grow;
2. To charge the highest fees the traffic will bear, limited only by loose regulatory constraints and even looser competitive norms;
3. To create the largest possible number of funds, appealing to the widest imaginable range of investor objectives....
4. To charge the maximum feasible amount for marketing and distribution, the better to encourage stockbrokers, fund salesmen, and independent advisers to offer the funds to their clients;
5. To utilize the brokerage commissions generated by the fund’s portfolio transactions to acquire marketing support and investment research, thereby obtaining these services without spending a single dollar out of the manager’s own pocket.”

These incentives, these drivers of conduct, are not at all connected with the fiduciary responsibilities of the manager to the beneficiary – not all of them are always hostile, but what is indisputable is that the energy and direction of the relationship is coincidental with the obligations of trust law. To be sure, managers and beneficiaries have a common interest in the optimal performance of the fund. “While the benefits are parallel, they are rarely proportional” as the fees generated by new business attracted by superior performance are not offset by increased expenses.

The conspicuous failure of the Securities and Exchange Commission to exercise any kind of oversight for the interest of beneficiaries continues to bewilder observers even after the prosecutorial zeal of New York State Attorney General Elliot Spitzer revealed massive fraud. “The commissions’ first failure is one of oversight. The mutual fund investigation began when an informant approached our office with evidence of illegal trading practices.

Tipsters also approached the commission, which is supposed to be the nation's primary securities market regulator, but the commission simply did not act on the information." The trade association for managers under the 1940 Act – the Investment Company Institute – has long been the envy of the lobbyist world. So great has been their power over the presumed regulator that the ICI is not entirely jocularly considered to be the parent company of the SEC.

Mutual funds and pension funds are not creatures of the common law, they are creatures of federal statute. One needs pause to inquire – what are we being told by a public policy that – notwithstanding principled opposition by such as Friendly – prefers the interest of the intermediary managers to those of the hundreds of millions of beneficiaries. To paraphrase a recent political slogan – "It's the money, stupid"; "...[A]t least a half-dozen owners of fund management companies accumulated person wealth in the billion-dollar level, including one family whose wealth is said to be at the \$20 billion level."

Signing the Employees' Retirement Income Security Act of 1974 ("ERISA") on Labor Day was Gerald Ford's first official act as President. The eleven years that had passed since President John Kennedy signed the authorization for the first study Commission of a National Retirement Policy on the plane on his way to Dallas produced a surprisingly broad consensus for a preemptive federal law. Among other things, ERISA provided a structure within which both companies and employees were comfortable agglomerating retirement assets and thus made clear two future developments: first, retirement assets subject to ERISA would constitute the largest shareholder of publicly traded American (and, in many cases, global) companies, and second, within a few years majority ownership of public companies would be held by fiduciaries, the scope of whose responsibilities would be determined under existing federal laws – ERISA and The Investment Company Act of 1940. At precisely this same time of majority "ownership", the dilution of the quality of "trustee" legal accountability inclined to neuter "ownership" of publicly traded U.S. companies. A trustee is in an unenviable position. By taking intelligent risks, he can not financially benefit himself; if those risks work out badly, he runs the risk of being surcharged. Some measure of the risk avoidance dynamic present in fiduciary bodies is manifest in the only substantive provision of ERISA relating to investment policy which stresses the importance of maximum feasible diversification. This may well have led to the wide spread use of "indexed" equity portfolios and to an industry that is compensated for generating relative returns, notwithstanding the need to pay retirees in finite amounts. The default setting for the fiduciary owner is passivity.

This tendency is exacerbated when real engagement with corporate management is contemplated. The size of institutional holdings "...gave opportunity and occasion for intervening in the affairs of the corporation whose shares were held, but they also carried a heavy moral, and in some outcomes perhaps a legal, responsibility for exercising such control as the shareholding might allow. Already under responsibility to those for whose benefit they held shares, professional fund managers did not seem anxious to incur further responsibility to their fellow shareholders in the companies in which they invested."

The modern institutional trustee in its incarnation as majority owner of American business has conflicts of interest of debilitating proportions. Notwithstanding the inveterate and unchanging rigor of trust law requiring the fiduciary to administer assets "for the exclusive benefit of plan participants" {language from ERISA}, today's conglomerate – understandably enough in a world where there is no enforcement - persistently favors its own interest in pleasing present and potential customers. There has been no enforcement of breach of fiduciary obligations either by the executive or judicial branches of government. In light of the trend of some courts towards the Law & Economics policy of "efficient compliance", there must be some doubt as to whether courts will require compliance with trust law.

What has emerged is a badly crippled owner. The General Accountability Office in 2004 investigated one aspect of fiduciary oversight by the Department of Labor of "ownership" responsibility for funds subject to ERISA – proxy voting of portfolio companies.

Reflect on the level of government protection of a hundred million pensioners: "DOL's enforcement of proxy voting requirements has been limited for several reasons... complaints are infrequent {because votes generally are not disclosed, so nobody knows whether they have been harmed}... legal challenges... difficulty in obtaining information... monetary damages are difficult to value."

Ironically, casting the majority owner of public companies in trust mode has twice cursed the beneficiaries. On the one hand, the trustees make extensive use of trust assets to protect themselves against any possibility of personal liability by hiring "consultants", the sum of whose contribution to the economic welfare of participants is highly problematic. Their real value is in providing trustees defense against any claim of negligence. Consultants improved on this to the extent of trampling "conflict of interest" notions by producing investment products that they sold to the funds they were supposed to be monitoring. At least one of these consulting companies was sold for in excess of \$1 billion; the principal of another famously bought a rather expensive extra terrestrial flight.

On the other hand, trustees, with “no skin in the game” were motivated to adopt the most minimalist policies of investment, thus insuring mediocre results. There probably are no thoroughly reliable statistics on the percentage of pension fund equities invested in index form, but it certainly is more than half.

Some years later, in 1986 the Federal Government again made a statutory pronouncement in the field of fiduciary ownership in the form of the Federal Employees’ Retirement Security Act. Congress provided an option for federal employees to invest a portion of their retirement entitlements among a range of indices – from bonds to equity. To the extent that beneficiaries chose to invest in an equity index, the statute plainly and unequivocally provides that no trustee or federal employee shall have any rights with respect to voting that stock.

To the extent that there is any “policy” respecting federal government attitude towards the voting of shares of private companies, both legislative and executive branches agree roughly – “hands off”.

In comparing governance in the United States with that in other countries, often one loses sight of the extent to which elsewhere government has recently and importantly been involved as a controlling owner of many of the most significant industries. America has traditionally licensed the “independent” power of the private sector. Ultimately, there will need be a day of reckoning and the license be subordinated to the public good.

We can justly be proud that fiduciary capitalism is widely understood to be the only formulation of energy and responsibility that gives promise of both wealth and fairness. We need accept and surmount the challenges of communicating a pure message of ownership concern and compelling conduct by trustees that accord with the inveterate and unyielding traditions of yore.