Making Corporate Governance Decisions that Work for Whom?

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Ten years ago, when I started an internet site on corporate governance, most in the United States would have answered that corporate governance decisions should work to maximize shareholder value, regardless of consequences to the larger society.[1] Although effort in corporate governance is still largely focused on that goal, several trends promise that corporate governance decisions might also contribute to a more sustainable society and environment.

While we have achieved significant reforms after the Enron debacle, we are now facing something of a stall and possibly retrenchment, at least from the standpoint of reforms I have been advocating and with regard to the central role played by the California Public Employees Retirement System (CalPERS).

CALPERS BACKGROUND

In the United States when most people think of corporate governance, especially with regard to active shareholders, they think of CalPERS, with $185 billion in assets. Their activism began in 1984 when California's Treasurer, Jesse Unruh, learned that Texaco had repurchased almost 10% of its own stock from the Bass brothers at a $137 million premium. Texaco's managers paid "greenmail" to avoid losing their jobs in a takeover. CalPERS, although also a substantial shareholder, wasn't given the same option so Unruh organized a powerful shareholder rights movement by helping to found the now $3 trillion dollar Council of Institutional Investors (CII), composed mostly of public pension funds. Corporate governance activities at CalPERS and CII were not aimed at creating a better society; they were aimed at strengthening shareholder rights and earning more money.

By the early 1990s, the movement started by CalPERS had led to a period of sweeping changes in boardrooms across America. CalPERS and CII won new regulations that allowed shareholders to communicate with each other about specific firms without filing Securities and Exchange Commission (SEC) documents. CalPERS targets, generally 10 to 12 poorly performing companies each year, became the subject of negative publicity and directors took action. Chief executive officers (CEOs) were ousted at American Express, Chrysler, General Motors, IBM, Kodak and Westinghouse.

In 1995, Steven Nesbitt published a study, which examined the performance of 42 companies targeted by CalPERS. It found that while the stock price of "focus list companies" trailed the S&P 500 Index by 66% in the five-year period before CalPERS acted to achieve governance reforms, the same firms outperformed the Index by 52.5% in the following five years. Nesbitt dubbed it the "CalPERS effect." A similar independent study by Michael P. Smith, with the Economic Analysis Corporation, concluded that corporate governance activism had increased the value of CalPERS holdings in 34 firms over the 1987-93 period by $19 million at a monitoring cost of $3.5 million.

EARLY CONCERNS OF CORPGOV.NET

Looking back at my earliest commentaries, one of the first was on fiduciary duty. I knew there was a growing shift in who controlled money. In the 1970s almost 80% of US equities were held directly by individuals. By 1995, when I started GorpGov.net, that proportion was considerably smaller and by 2002 it fell to just over 37%. Institutions, bound by fiduciary obligations, control the rest.[2] I felt the key to future corporate behavior depended on the voting behavior of pension funds and mutual funds in corporate elections.

I was familiar with a 1988 Department of Labor (DOL) opinion (the Avon Letter) that, since proxy voting can add value, voting rights are subject to the same fiduciary standards as other plan assets. But I also suspected that most funds were shirking their duty. I read the findings of three DOL proxy-monitoring projects conducted between 1989 and 1996. In 1989, DOL said they would continue to conduct inquires and, "where appropriate," would "take enforcement action." No enforcement action has been taken to date.

By 1996, still only 35% of the plans surveyed could provide evidence that they performed substantive monitoring of voting authority delegated to money managers. Of those that delegated proxy-voting authority, only 38% provided written guidelines to investment managers and some were general to the point of irrelevance, since the law already required "vote proxies in the best interest of the client." Although DOL interpretive bulletins indicated that prudent shareholder activism was consistent with a fiduciary's legal obligations, only one investment manager reviewed by DOL was so engaged.

The best answer I could find as to why pension plans shirked their duty was in a 1992 book*Fortune & Folly* by William M. O'Barr, John M. Conley, and Carolyn Kay Brancato. The authors used the tools of anthropology to locate a common thread in the culture of pension funds. What they found was "an overriding concern with managing personal relationships" and an all-pervasive "need to manage responsibility and blame."

Involvement by fund trustees in corporate governance issues was not yet the norm. The duty of care requires them to act after due consideration with the care that a "prudent person" would take in a similar situation. The legal system made it difficult to do anything but "follow the herd." I later learned the same person, Robert A.G. Monks, who was instrumental in the Department of Labor's Avon Letter, was also instrumental in prompting a letter that set similar duties for mutual funds many years later.

I used my internet site to publicize the CalPERS effect and studies that showed funds could earn more money by targeting poorly performing companies for reforms, investing more heavily in firms with fewer management entrenchment devices, such as poison pills, and by taking an active role in corporate governance.[3] However, I also argued that funds could increase earnings by investing in companies that shared power with their employees.

This was a "double bottom line" argument. Funds wouldn't have to sacrifice returns by investments that would also have benefits to society. If workers were empowered at work, they would take that sense of empowerment into the political realm as well. Employees who are not involved in significant decision-making at work are less likely to be involved in politics and a democratic government, such as ours, depends on the intelligent participation of its citizens.[4] Additionally, employees would be more concerned than absentee shareholders about issues like worker safety and environmental protection. Most employees live near work and they want a clean environment for themselves and their children.[5]

I thought the U.S. should be ripe for such arguments because of the growing importance of "intellectual capital." Tangibles contributed by financial capital, such as property, plant and equipment, had accounted for 62% of the total value of mining and manufacturing firms in 1982, but only for 25% more recently.

Margaret Blair made a significant contribution to my understanding of "knowledge work" and its application to corporate governance. She contends that employees, like shareholders, have firm-specific investments at risk, in the form of human capital. The key to wealth maximization is to be found in providing ownership-like incentives to "those who control critical specialized inputs."

In its April 1998 report, *Corporate Governance: Improving Competitiveness and Access to Capital in Global Markets*, an advisory group to the Organization for Economic Co-operation and Development (OECD), led by Ira Millstein, gives a nod to aligning the interests of employees with corporate performance through stock-based incentive. Millstein notes that, increasingly, the board becomes a "mediator of rents." "The more important human capital is to a business, the more those investors should stand to gain – or lose – and the greater voice they should have in governing it." More democratic workplaces make better use of employee capacities and generate more wealth.[6]

It is paradoxical that autocratic practices are justified by alleged efficiency, since the research does not support that conclusion. In fact, increased rank-and-file responsibility, increased participation in decision-making, and increased individual autonomy are associated with greater personal involvement and productive results. Even department store clerks are crucial to profits. Sears, for example, found that if employee attitudes improve by 5%, customer satisfaction jumps 1.3%, resulting in a 1/2% rise in revenue.[7]

Why do organizations allow workers so little control over their jobs? Most decision-making structures are designed around status needs related to dominance and control; they are not designed to maximize wealth creation. In order to gain higher status, individuals seek to dominate more and more people by shifting important decisions upward, far away from the problems being addressed and most of the information sources. Even if complete information can be instantaneously transmitted to the top, those managers are unlikely to have all the required expertise to address the depth and breadth of issues that inevitably arise in a large corporate structure. Governance structures that provide greater opportunities for participation, both at the board level and at the shop floor, make better use of all the information and expertise available, generating more overall wealth.

I pushed employee ownership and participation as a means of obtaining "double bottom line" returns knowing that CalPERS already had some experience with this concept. In the early 1990s CalPERS established a home loan guarantee program. That program has earned CalPERS 20% a year, allowed employees to buy homes at lower interest rates, and has generally stimulated California's economy and the tax base that employs public sector workers.

TRANSITION IN CONSCIOUSNESS

In the mid to late 1990s one of the issues that socially responsible investors (SRIs) focused on was tobacco. It was also a concern to many members of CalPERS, who spent their days working to convince children not to start smoking, to help adults quit, and to deal with tobacco related illnesses. I remember attending a seminar where one of the board members of CalPERS defended tobacco investments, saying he had a fiduciary duty to make as much money as possible for CalPERS, regardless of the social consequences. In fact, he said he had a fiduciary duty to invest in prostitution, addictive drugs, or anything else that would bring more money to the fund, as long as such investments were legal.

Even though many of the same directors still sit on the CalPERS board, their attitudes changed. They sought to have targeted firms emphasize innovative practices in the workplace and they divested tobacco holdings in 2000. CalPERS went on to issue corporate governance standards for emerging markets countries based, in part, on political stability and labor standards. They got involved in campaigns on global warming at ExxonMobil. They pushed oil and auto companies not to fight new regulations in California that would reduce global warming by requiring increased fuel efficiency.

As I write this in March 2005, CalPERS and the California State Teachers' Retirement System (CalSTRS) are sponsoring a "Green Wave" investment conference, pledging to invest $1 billion in "clean" technologies ranging from rechargeable battery makers to manufacturers of fuel-cell membranes. They will also audit their $16 billion real-estate portfolio "to use clean energy, energy efficiency and green building standards." Experts say these ventures could grow into an $11 billion to $25 billion industry in California over the next decade and could also help slow global warming.

What happened? Of course, I would like to take credit for the change. After all, I ran for the CalPERS board, raised issues on my internet site, and encouraged SRI funds to focus more on corporate governance and corporate governance advocates to unite with SRI funds on various issues. However, if any one person has shaped this direction recently it has beenCalifornia State Treasurer Phil Angelides who has played a critical role in emphasizing double bottom line returns. He sits on the boards of both CalPERS and CalSTRS, the first and third largest public pension funds in the U.S.

UNIVERSAL OWNERS

Of course no one person is responsible for the shift, which has systemic causes first discussed by Robert Monks and more fully elaborated by James P. Hawley and Andrew T. Williams in their book, *The Rise of Fiduciary Capitalism* and in a more recent paper, *Shifting Ground: Emerging Global Corporate Governance Standards and the Rise of Fiduciary Capitalism*. Their basic thesis is that as institutional investors have grown, especially those with indexed funds, they have become "universal owners." Just as owning shares in both companies during a merger provides a different perspective, so does owning a bit of just about everything in the market.

Universal owners have a particular interest in issues that affect the economy as a whole. While owners of a specific firm may seek to increase gains by externalizing costs, by polluting the environment, or paying workers so little they are dependent on public welfare, universal owners are largely dependent on a rising market. Issues such as fiscal policy, infrastructure, education, and worker health, and safety standards that generate a positive environment work in their favor. Their returns – and their ability to meet their fiduciary duties – more often depend on how well state, national, and increasingly international economies perform. CalPERS, for example, is disproportionately invested in California but also has 31% of its equity investments abroad.

Fiduciary duty, based on the duty of loyalty and the duty of care, begins to change. Universal owners begin to consider not just current beneficiaries but those who will be retiring forty years from now. They begin to see the need for national and international corporate governance standards, fiscal policies, infrastructures, and other elements that drive the economy as a whole. When reinsurance giant Swiss Re issued a report warning that natural disasters worsened by global warming could cost insurers $49 billion in claims annually by 2014, universal owners such as CalPERS and CalSTRS paid attention.

Hawley and Williams point out that since active ownership "carries with it the need for certain shareholder rights (timely access to proxies, an ability to vote and to have those votes count, for example), it follows they must then seek global standards that will enable them to fulfill their fiduciary duty at any company in which they own shares." They point to the growing role of organizations such as the International Corporate Governance Network with $10 trillion in member assets, the OECD, the World Bank's Global Corporate Governance Forum in setting international standards for disclosure, insider trading, protection of minority shareholder rights, etc.

Financial service firms such Moody's, Standard & Poor's and Fitch, as well as proxy advisory firms such as Investor Responsibility Research Center, Institutional Shareholder Services (ISS), and Glass Lewis bring the weight of the market to bear on such standards, impacting the terms on which capital is made available. Non-governmental organizations (NGOs) such as the Coalition for Environmentally Responsible Economics and the Global Reporting Initiative have also begun framing environmental concerns in terms of risk, expanding the boundaries of fiduciary duty into areas previously the sole domain of SRI funds.

Of course governments have also played a significant role. Of three most significant SEC proposals, two were enacted; one was not. On September 20, 2002 the SEC proposed two sets of rules, one for mutual funds, the other for investment advisors.[8] Both embodied the notion that since proxy voting can add value, voting rights are subject to the same fiduciary standards as other plan assets.[9] Both required disclosure of policies and votes. After thousands of comments (mutual & advisors), overwhelmingly in support, and resistance from the Investment Company Institute to the requirement to disclose all votes, both rules wereadopted in early 2003.

Many mutual funds and investment advisors have a blanket policy of voting with management on all "social responsibility" resolutions. The new rules make it harder to justify such rubber-stamp policies and will make funds and advisors more accountable to investors. Additionally, with votes now accessible, the impact of potential conflicts of interest, such as voting in a company's election while managing their 401(k) plan, can be more easily determined. For example, according to Michael Garland with the AFL-CIO, "Fidelity earns more than half its revenue selling fee-based services to corporations–the same companies whose proxies they're voting on."

The SEC proposed an even more important rule, Security Holder Director Nominations, on October 14, 2003. What prompted the proposal? Post-Enron, more shareholders began to recognize the danger of CEOs playing a dominant role in selecting directors and that corporate "elections" were elections in name only. Les Greenberg, Committee of Concerned Shareholders, and James McRitchie, of CorpGov.net petitioned the SEC on August 1, 2002 to allow shareholders to use proxy proposals to nominate and elect directors. The Council of Institutional Investors said our petition "re-energized" the "debate over shareholder access to management proxy cards to nominate directors." Soon, internet group eRaider and the AFL-CIO followed suit with additional petitions.

The idea was to provide a low-cost way for shareholders to run alternate candidates for board seats. As we wrote in our petition, "entrenched managers and directors will only improve corporate governance when they can be held personally accountable, e.g. voted out of office and replaced." Access to the proxy would allow investors to run their own candidates for the board at an affordable cost. "Equal access to board nominations is the holy grail of corporate governance reform," said Patrick McGurn of ISS.

Finally, in October 2003 the SEC proposed a weak rule that would make it easier for shareholders to nominate a token number of directors, which they predicted might happen at 45, or 0.3%, of companies each year. CalPERS, CalSTRS, and thousands of others supported this as a "foot in the door." In fact, the rulemaking received more favorablecomments than any SEC proposal in history. However, it so disturbed corporate managers that the U.S. Chamber of Commerce threatened to sue the SEC if the rule was enacted. The Business Roundtable, made up exclusively of top CEOs, placed ads in major newspaperssigned by CEOs of 40 large corporations, warning the proposal would erode the independence of directors. However, while it is important for directors to be independent of managers, it does not follow that directors should also be *independent* of shareholders. That is like advocating that politicians should be independent of voters. In fact, the solution to the problems surrounding entrenched management is to make directors *dependent* on shareholders and managers dependent on board members.

Throughout the summer of 2004, SEC Chairman William Donaldson kept announcing he would push forward. "The need for action," he said, "can't stop for partisan politics."[10] Yet, during President Bush's innately appealing campaign discussions of an "ownership society," he failed to endorse the idea of giving shareholders a greater stake in selecting corporate directors… of taking an ownership role. Many took Bush's reelection as a sign that CEOs could push back. The "equal access" proposal was dead.

CALPERS UNDER ATTACK

Even before Bush's reelection, the call went out against CalPERS. In an editorial during the spring of 2004, the Wall Street Journal accused the fund of taking the governance issue "to absurd new lengths" and advancing its own prounion political agenda. The U.S. Chamber of Commerce said CalPERS was in need of reform. The San Francisco Examiner indicted the fund's proxy campaign as "strident." Disappointed with CalPERS votes against corporate directors, the California Republican Party issued a statement in the spring of 2004, "How unfortunate that the 1.4 million people served by Calpers — not to mention taxpayers — can't sit across the table from the recalcitrant Calpers board and shout, 'You're fired!'"

In January 2005, Governor Arnold Schwarzenegger released his official plan to curb California spending. A key feature is a proposal to amend the state constitution prohibiting public employees hired after 2007 from being covered by a defined contribution plan. At least initially, the public appears ready to accept the word of an action-hero governor who pitches the plan as a money saver, even though it is likely to cost taxpayers billions and may force future public sector retirees into poverty. According to a poll by the Public Policy Institute of California, 61% favored his plan, while 25% opposed it.

There are few rational arguments in favor of such a change. Requiring two systems during a forty-year phase-out won't save taxpayers money. It will result in lower retirement benefits for the vast majority of new public employees. According to the San Francisco Chronicle, the median DC plan return from 1990 through 2002 was 6.86 percent. For the same time period, CalPERS' rate of return was 8.9 percent. Public employment will be far less attractive, so levels of service will continue to deteriorate. And, it will wipe out inflation-fighting pension protections for existing employees. So why the proposal?

One obvious reason is that some want to feed at taxpayer expense. It costs 0.37% to administer the CalPERS defined benefit (DB) plan, but will probably cost more than 1.5% per year as a defined contribution (DC) plan, with no death/disability benefits or inflation protection. If California funds have assets of approximately $500 billion (CalPERS and CalSTRS alone have $300 billion), the yield to money managers will be an extra $5.65 billion every year while earning $10.2 billion less for public employee retirements every year.

Second, Schwarzenegger raised more than $23 million in political donations in 2004, using the money for initiative campaigns, travel, and fundraising. The DB to DC initiative will help him raise a fortune – at least $50 million to fund his 2005 initiatives and another $50 million for his reelection campaign. And the amount to be raised for initiatives may be understated, since these are not subject to the reelection campaign limits of $22,300 per donor. Schwarzenegger will raise more money than all candidates but the President.

However, another huge reason is the role CalPERS, CalSTRS and other public funds have taken in corporate governance. The Howard Jarvis Taxpayers Association is now collecting signatures to put an initiative on the ballot. Their president, Jon Coupal, said the proposal seeks to end "the social engineering and corporate governance agenda" of CalPERS. Why do powerful forces want to end traditional pension funds, especially public pension funds? Because pension funds are the primary check on the power and greed of corporate CEOs. CalPERS has been a leader in the effort to bring accountability to corporate boardrooms. In November 2004 they announced their next major target – CEO pay. Could that have something to do with the current attack?

All of the CEOs in the S&P ExecuComp database have defined benefit plans. Of course, qualified pension plans (exempt from taxation) are limited to about $200,000 a year and the average S&P 500 CEO earns much more. Supplemental executive retirement plans, known as SERPs, are an inefficient way to compensate CEOs but they come with one great benefit –camouflage. "Neither the increase in value of the SERP plan before retirement nor the amount of payments after retirement appears in the compensation tables, the existence of SERPs, and the formulas under which payouts are made must be disclosed in the firm's SEC filings." While CEOs want to keep their owned defined benefit plans, they want to outlaw them for public employees.

CONCLUSION

Killing public pension funds would allow CEOs to wield power nearly without accountability, since public pension funds have been the primary corporate governance watchdogs. As has been shown in many studies, firms with stronger shareholder rights that protect against entrenched managers have higher values. The most frequently quoted study is Corporate Governance and Equity Prices by Paul Gompers of Harvard and Andrew Metrick of the University of Pennsylvania's Wharton School.[11] As more such studies are published, institutional investors that vote in favor of weakening shareholder rights could face legal action for violating their fiduciary duty.

Would such studies stop being written if public pension funds in the U.S. were terminated? Not entirely, but making corporate decisions that work for society-at-large depends on instilling corporate values that guard against negative impacts on society and the planet. Most corporations need prodding from government, activist shareholders, rating companies, and NGOs to realize those values. Take away large players in any of those sectors and we suffer setbacks. Without CalPERS, who will set the new fiduciary standards that allow us to save the people and the planet? Who will make the herd run? Let us hope Californians are not misled when they vote this November.

Addendum: On the morning of April 7, 2005 California's Governor withdrew his support of the initiative that would have outlawed defined benefit pension plans for all public employees in California. When voters began learning the initiative would eliminate death and disability benefits, images of disabled police and firefighters, as well as their widows, drew hundreds of protestors to Schwarzenegger's fund-raisers. His approval rating dropped below 50%. "I have decided to work together with leaders in local government and public safety to craft new initiative language that makes it absolutely clear that the families of every cop, firefighter and public safety professional lost in the line of duty are protected in our pension reform plan," said Schwarzenegger. "I think it is better to improve the language and put our plan on the June 2006 ballot," he said. (see Full Text of Governor Schwarzenegger's Pension Reform Announcement – April 7, 2005)

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1. "A corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain." American Law Institute, *Principles of Corporate Governance*, (1994).

2. Hawley, James P. and Andrew T. Williams, *Shifting Ground: Emerging Global Corporate Governance Standards and the Rise of Fiduciary Capitalism*, November 20, 2003 draft, cited with permission.

3. For a list of more current studies.

4. *Participation and Democratic Theory* by Carole Pateman

5. *Participatory Economy* by Jaroslav Vanek

6. A 1986 study by the National Center for Employee Ownership found firms with significant employee ownership and participation in decision-making grew 8 to 11% faster than their counterparts. See the results of more recent studies athttp://www.nceo.org/library/option_corpperf.htmlhttp://www.nceo.org/library/option_corpperf_neweconomy.html
http://www.nceo.org/library/esop_perf.html

7. Wall Street Journal, 7/22/98, page B1.

8. These rule proposal responds to rulemaking petitions filed with the SEC by the AFL-CIO (Dec. 21, 2000) (http://www.funddemocracy.com/AFL-CIO%20Petition.htm), the International Brotherhood of Teamsters (Jan. 18, 2001) (http://www.funddemocracy.com/Teamsters%20Petition.htm), and Amy Domini, founder and Managing Principal of the Domini Funds (Nov. 27, 2001). See http://www.domini.com/about-domini/News/Press-Release-Archive/Proxy-Voting-Ltr-to-SEC-12-01.doc_cvt.htm Proposalsat http://www.sec.gov/rules/proposed/33-8131.htm and http://www.sec.gov/rules/proposed/ia-2059.htm

9 February 12, 2002, SEC Chairman Harvey Pitt letter to John P.M. Higgins, Ram Trust Services, “An investment adviser must exercise its responsibility to vote the shares of its clients in a manner that is consistent with its fiduciary duties under federal and state law to act in the best interests of its clients.” Monks and/or Nell Minow and Ram Trust had inquired 13 years earlier and kept resubmitting. Monks also personally met with Pitt in July 2002 to discuss all three rulemakings.

10 Fortune, September 20, 2004.

11 “Firms with stronger shareholder rights had higher firm value, higher profits, higher sales growth, lower capital expenditures, and fewer corporate acquisitions.” Investors who bought firms with the strongest democratic rights and sold those with the weakest rights “would have earned abnormal returns of 8.5 percent per year during the sample period.”http://icf.som.yale.edu/Conference-Papers/Fall2001/gov.pdf
See also Bebchuk et al. (2004) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=593423, GovernanceMetrics International (2003 and 2004)http://www.gmiratings.com/(113im3i3xjepxv55aauigabn)/Performance.aspx, Drobetz et al. (2003) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=379102,
Bauer et al. (2003) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=444543,
Gugler et al. (2003) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=299520, and
McNabb and Martin (1998) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=102688.