The Ownership of Corporate America -- Rights and Responsibilities

Keynote Speech by
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I'm enormously honored by the invitation to address you at your landmark 20th Anniversary meeting. The Council of Institutional Investors has been a true pioneer in addressing the crying need to improve corporate governance and strengthen shareholder rights at U.S. companies, and has provided an effective forum for the public and union pension funds that constitute your general membership roll. I salute you.

It is hardly a secret that today institutional investors, including your own large membership, collectively hold absolute control over corporate America. But it is truly amazing how little attention has been paid to the implications of this sea change in the nation's ownership system. These issues, surrounding the governance of America's corporations and mutual funds, are at the core of my new book, *The Battle for the Soul of Capitalism*, which will be published by Yale University Press this September.

The book evaluates corporate America, investment America, and mutual fund America on three levels: 1) What went wrong in each arena; 2) Why it went wrong; and 3) How to fix it. Today, I'd like to direct my remarks largely to what I describe as "investment America," with a particular focus on both the *rights* of corporate owners, where there is much activism and about which much has been written, and the *responsibilities* of corporate owners, about which there has been far less introspection and dialogue. Yet we must all realize that even as our role as individual citizens involves responsibilities as well as rights, so does our role as corporate citizens.

A Sea Change in Ownership

The institutionalization of U.S. investing surely represents a dramatic sea change in the nature of capitalism. The fact is that when Berle and Means published their landmark study, *The Modern Corporation and Private Property*; in 1932, there were, almost literally, *no* institutional owners of stocks. Nonetheless, their concerns seem almost eerily prescient today. They warned that "the position of ownership has changed from that of an active to that of a passive agent, (with the) 'owner' of industrial wealth left with a mere symbol of ownership, with the power, the responsibility, and the substance . . . of ownership transferred to a separate group (the corporate managers) in whose hands lies control." Those words could have been written, with equal accuracy, this very morning!

In essence, Berle and Means' thesis was based on the arrogation of the levers of power by managers that takes place when corporate ownership is diffused among legions of individual investors. When they wrote their study, stocks were at deeply depressed levels, and the total capitalization of the U.S. stock market was just $23 billion. They could hardly have imagined today's near-$14 trillion total, a mere 600-fold increase. Nor could they have imagined the remarkable institutionalization of investment America that would begin two short decades later.

It is generally accepted that the inclusion of common stocks in the General Motors Pension Plan in 1950 marked the beginning of that powerful trend toward institutional ownership. Stock ownership by private pensions, zero percent as 1950 began, rose to almost 8 percent in 1965 and to 24 percent in 1985. While ownership by *private* plans has now eased to 17 percent, ownership by *public* pension plans has risen to 9 percent, bringing current retirement plan ownership to 26 percent of all U.S. stocks.

In a parallel trend, mutual fund ownership of equities also burgeoned. Since 1950, fund ownership has risen from about 3 percent of corporate equities to today's 25 percent (including some 5 percent through fund shares held in defined benefit and defined contribution plans). When we include other institutional owners such as insurance companies and endowment funds, institutional investors as a group now own some $9.3 trillion of U.S. stocks, or 66 percent of the total. Those individual owners, who held virtually 100 percent of all shares when Berle and Means' book was published, now constitute just 34 percent of the total. *Sea change* is an understatement; we have truly witnessed a revolution in stock ownership.

The Institutional 100

Unlike the large but inchoate individual population of stockholders that Berle and Means described in 1932, a remarkably small group of institutional managers now dominate the ownership scene. The largest 300 managers hold $7.5 trillion of stocks, 56 percent of the U.S. stock market's total capitalization of $13.2 trillion. This ownership is highly concentrated: the largest 100 managers alone hold 52 percent of all shares, $6.8 trillion in U.S. equities. This relative handful of giant investors have the real—not merely the theoretical—power to exercise dominion over the corporations they own. The largest ten firms alone—managing from $150 billion to $525 billion of equities—hold 25 percent.

When the surge of institutional investing began a half-century ago, there were two fairly distinct investment cohorts, private pension managers and mutual fund managers. Today, however, all but two firms among what I describe as the Institutional 100 now manage both pension accounts and mutual funds. In some cases (e.g., Vanguard and Fidelity), mutual fund activities predominate; in others (e.g., State Street Global, Barclays Global), it is pension management that predominates. Where once there were two private cohorts, now there is one.

In addition to these giant private managers, there are thirteen state and local government retirement plans included in the Institutional 100, owning $390 billion of equities or 5.7 percent of the total and ranging from California Public Employees' Retirement System holding $56 billion of U.S. equities (number 54) to Colorado at $12 billion.[1]

With this melding of the ownership interests of private and public pension plans and mutual funds, institutional investing is now a virtual totality, with the power to become the dominant force in investment America. But while easy enough to lump the combined private and the mutual fund sectors with the public sector as "institutions," their structures and operations are vastly different. The differences, it turns out, are huge.

[1] Other giant public retirement plans include Texas Teachers, New York State Teachers, New York Common Retirement, Florida, and New Jersey.

I. Private Plans and Mutual Funds

Let's start with the managers of private retirement plans and mutual funds. They are fiduciaries under the law, duty bound to serve solely the interests of their pension beneficiaries and fund shareholders. The Investment Company Act of 1940, for example, states that mutual funds must be "organized, operated, and managed" in the interests of their shareholders "rather than the interests of their managers and distributors."

Yet, fully 41 of the 50 largest private managers are publicly-held enterprises, which, one must presume, also have a fiduciary duty to the shareholders of the organizations that employ them. To complicate the issue, only three of those 41 firms are owned directly by the public. The remaining 38 firms are subsidiaries of giant U.S. and international financial conglomerates: Citibank, Mellon, Northern Trust, Sun Life of Canada, Marsh & McClennan, Bank of America, Deutsche Bank, Allianz, AXA, and so on.

Voting Conflicts – An American Keiretsu

Almost without our realizing it, a system of *circularity* has developed in which the owners are also the owned. For through the private pension plans, thrift plans, and mutual funds that they manage, trillions of dollars worth of shares of other U.S. corporations are in the hands of the corporations themselves, a sort of American *Keiretsu*[2], whose firms, at least tacitly, look after their own collective interests.

For example, the accounts managed by Citigroup's money management arm now hold some 42 million shares of Citigroup itself. That holding, almost one percent of the bank's 5.1 billion shares, is huge in and of itself. When combined with Citigroup shares held by other managers who face the same conflicts, reinforced by the common ownership of other managers controlled by these conglomerates, the aggregate is enormous. (Institutions own about 65 percent of Citigroup's shares.) Small wonder that we're never quite sure who is paying the piper and calling the governance tune, and with what motivation. This is not merely asking the fox to mind the henhouse. It's more like asking the fox to mind the foxes in the henhouse.

Practical voting issues are easy to imagine. Suppose there were a proxy proposal to separate the jobs of chairman and CEO of Citigroup, where a single individual now holds both positions. How would the Citigroup investment management officials vote the Citigroup shares they hold? What process would they use to decide? What if their money managers believed that the proposal to separate the roles was good governance policy, but the CEO of Citigroup wanted to keep both of his jobs?[3] While rarely discussed, the obvious conflicts that arise from this circularity of ownership and control raise important policy questions about the fulfillment of fiduciary duty that money managers and trustees owe to their ultimate owners and beneficiaries.

Economic Conflicts

Voting conflicts that are at least potential, then, exist and so do economic conflicts. Is the primary goal of all those firms that own fund management companies to earn a return on their *own* capital or earn a return on the *fund shareholders'* capital? To make matters worse, the fiduciary duty of private

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[2] "Keiretsu" is a Japanese word that refers to a group of businesses that share an ownership stake in one another as a means of mutual security.

[3] A Citicorp representative with whom I discussed these questions earlier today told me that such decisions were left solely to their investment managers.

money managers to their beneficiaries entails what can fairly be described as a dollar-for-dollar conflict of interest with the fiduciary duty that they owe to their own owners. *The higher the fees paid to the manager, the lower the returns earned by the beneficiary*.

In the mutual fund field, for example, the low-cost quartile of funds produced a risk-adjusted return averaging 12 percent per year during the past decade; the high cost quartile a return of just 9 percent. Compounded over the decade, the cumulative profit of the low-cost funds was nearly *double* the return of their high-cost cousins—about $3 for each $1 initially invested vs. $2. Just think about that! The stark and obvious conflicts of interest between manager and beneficiary that exist in corporate governance issues and in basic economic issues gives new meaning to the ancient Biblical injunction: "No man can serve two masters."

For whatever reason, the forbearance of these private institutions from the corporate governance process has become legend. Despite the gross excesses of corporate America in the recent era, the very same time that the Institutional 100 of investment America has risen to power that is at least theoretically beyond challenge, the participation of private pension plans and mutual funds has been virtually absent, not only from the governance scene, but from legal and regulatory processes aimed at reforming our faltering system. Consider this astonishing lack of participation. As far as I can tell:

- No mutual fund firm, pension manager, bank, or insurance company has ever sponsored a proxy resolution that was opposed by the board of directors or management.
- Not a single institutional manager testified before Congress regarding the expensing of options, despite the fact that they must have had an opinion.
- No institutional investor testified before Congress about the most significant piece of legislation affecting public companies in the last 50 years, the Sarbanes-Oxley reform bill.
- No large shareholder has urged the Financial Standards Accounting Board to get on with the job of requiring stock options to be expensed.
- No senior executive of a major mutual fund complex has spoken out on the subject of the rights and responsibilities of either corporate shareholders or mutual fund shareholders.

Part of the reason is the clear conflict of interest that private managers face in administering the retirement plan assets of the very corporations whose shares they hold, and collectively control. While industry leaders regularly deny that such a conflict exists, it is hard to imagine that a private institutional manager would be eager to vote against an entrenched corporate management that has hired it to supervise its multi-billion-dollar pension plan or 401(k) thrift plan. And even when a governance or proxy issue involves a corporation that is not a client, the reluctance to speak out persists, giving credence to this perhaps apocryphal comment by a pension fund manager: "There are only two types of clients we don't want to offend: actual and potential."

II. Public Retirement Plans

Public retirement and union plans, alas, are hardly bereft of conflicts of interest. But they are very different ones, so (with a slight touch of trepidation!) I now turn to your area. Fiduciary duty is also the obligation among public retirement and union funds. It entails neither of these conflicts. Since public fund and union fund manages to face neither the voting conflicts nor the economic conflicts confronted by private sector management, in theory at least, you can dedicate themselves solely to the interests of the state and local employees and teachers whom they are duty-bound to serve, without fear or favor. As a result, most corporate governance activism has been left largely to public funds and union funds, and to TIAA-CREF, which, it almost goes without saying, have been far more aggressive in asserting their ownership rights, confronting managements, making proposals in corporate proxies, and even actively joining in the campaign to require mutual funds to report to their shareholders on how they vote their proxies.

Does this difference between public and private plans matter? It surely seems to! Consider some of the areas in which we can actually measure the differences:

- The ratio of management costs to total assets for public funds is a small fraction of that of private plans—perhaps (the data are hard to come by) 10 to 20 basis points vs. 50 to 70 basis points.
- When public plans retain private managers, they pay a small fraction of the fees paid by the managers' mutual funds. In 2002, Calpers, for example, paid an average fee of 8 basis points, totaling $600,000, to each of three managers whose comparable mutual funds paid them 61 basis points and $56 *million*!
- Public plans appear far more likely than their private counterparts to rely on minimum-cost passive stock indexing. For example, the second largest of all public plans, the Federal Retirement Thrift Savings Plan, indexes 100 percent of its equity investments.
- While private plans and mutual funds typically observe the Victorian standard, "Silence is Golden," public plans as a group are active participants in corporate governance.

This is not to say that public funds and union funds are bereft of conflict of interests. While your particular structure and *modus operandi* is clearly free of the same conflicts that plague your private counterparts, as political entities you are all subject to the control of your legislatures, and the ultimate influence, if not the jurisdiction, of elected officials and unelected administrators with their own political objectives, and potential conflicts are rife. For example:

- Have you ever felt pressure to divert the retirement plan assets of state employees and teachers from high-grade marketable securities to projects designed to effect social change, without adequate regard to risk or return?
- Have you ever been pressed to hire or retain managers because they have contributed to public officials' election campaigns? (It's called "pay to play.")
- Have you ever been pushed to terminate private managers who may have taken public positions with which you disagree?
- Do you have trustees who make excessive use—or any use!—of dinners, golf outings, trips, boondoggles (if there's a difference!) provided by any of your service providers?

I'm sure this list only scratches the surface of the political pressures you face. Of course, if you are as pure as Caesar's wife on these and other related issues, please disregard these implicit criticisms. But if, despite your best efforts, you are not quite so pure, please realize that the absence of the profound conflicts of interest that plague private plans and mutual funds in no way suggests that public plans are pristine. You face different conflicts, yet your fiduciary duty remains clean and pure: to place first, in all ways large and small alike, the interests of those millions of souls whose retirement savings have been entrusted to your care.

III. Rights and Responsibilities

Let me now turn to the rights and responsibilities of ownership. There is an old saying that goes: "When we have strong managers, weak directors, and passive owners, don't be surprised when the looting begins." While the cases of *conventional* looting in corporate America have been relatively rare—and at least some of the miscreants are in, or on their way to, jail—the *unconventional* looting—call it by the oxymoron "legal looting"— has been rife: Financial engineering; absurd assumptions about future pension plan returns; cookie-jar merger accounting; restated earnings (without restated bonuses); and egregiously excessive issuance (and exercise) of stock options only begin the long list.

Since all institutional investors are fiduciaries, it is obviously high time for us to exercise both our rights and our responsibilities of corporate citizenship, thoughtfully voting our proxies and constructively communicating our views to corporate management. The S.E.C.'s 2002 decision to require that mutual funds disclose to their owners how the funds vote their owners' proxies—proxies, to be clear, that should always be voted in the interests of the *owners* rather than in the interests of *managers*—was a long overdue first step in the process.

Yet the mutual fund industry was dragged, kicking and screaming, into providing this disclosure. In December 2002, deeply concerned about the industry's opposition to the S.E.C. proposal, I wrote an op-ed essay in *The New York Times*, arguing in its favor: "Fund managers are the agents; fund shareholders are the principals . . . our shareholders are owners of the stocks; to deny them information (about how funds voted their proxies) would stand on its head the common understanding of the principal-agency relationship . . . By their long forbearance and lassitude on governance issues, funds bear no small share of the responsibility for the failures in corporate governance and accounting oversight that were among the major forces creating the recent market bubble . . . If the owners of our corporations don't care about governance, who else is there to assume that responsibility?" Three months later, the Commission accepted that common sense argument, ordering that its proposal become effective on August 31, 2004. We have already seen a sharp increase in the participation of funds in the proxy process, often voting against excessive option issuance, withholding votes for directors with business conflicts, and voicing their views on other corporate policy issues.

Proxy Access

But the *motive* to vote, regularly and thoughtfully, created by disclosing our proxy votes to fund owners is only half the battle. All financial intermediaries, private and public alike, also need the *opportunity* to act. We need fair access to corporate proxy statements so that we can place, directly in proxies, both nominations for directors and proposals on business conduct, including compensation policy. Yet despite the failure of so many corporate directors to act as faithful stewards to their shareholder owners during the recent era, it remains virtually impossible for shareholders to nominate their own candidates as directors.

When the S.E.C. promulgated its 2003 proposal to open the door to shareholder "access" to corporate proxy statements (or, more accurately, to ease the door ajar just a tiny crack), it was the public funds and union funds almost alone among institutions that urged adoption, also with some 17,000 individuals. Yet almost unanimously the private managers spoke with the sound of silence that has become almost an industry tradition. In fact, some of the largest managers either flatly opposed the access proposal, or didn't comment at all or favored making the access even more restricted.[4] "We don't want access," is the only conclusion. Public funds and union plans, on the other hand, were aggressive supporters of the proposal, with 50 public plan managers joining to make constructive comments in its support with 21 union plans in agreement. I applaud the Council of Institutional Investors for your cogent, simple, and splendid letter.

[4] The firms opposed included: Barclays, J.P. Morgan Chase, Northern Trust, and Schwab; the firms with no comments included: Fidelity, Vanguard, Putnam and MFS; the firm recommending greater restrictions was Capital Group.

Despite your enlightened support for access to board nominations, the Commission now seems to be drawing back from even the limited access available for making proxy proposals, first approving, and subsequently reversing itself and denying, an effort by stockholders of Disney to propose that shareholders have a specific right to nominate their own board candidates, and later allowing management of three other large corporations to exclude similar shareholder proposals. The icing on the cake was the most recent case, in which a shareholder proposal to separate the responsibilities of chairman of the board from those of the chief executive at ExxonMobil, surely a provision that common sense commends, was allowed to be excluded. ("The boss of the business vs. the boss of the board," as I put it, "*It's called separation of powers*.") Corporate governance pioneer Robert Monks was particularly appalled at this decision by the SEC, calling it "the death of corporate democracy." This resistance by the Commission to proposals that are merely precatory (non-binding) is inexplicable, except as a testimony to the power of corporate influence.

Alas, the current gossip is that even that the Commission's weak initial proposal is now dead, killed off by the Business Roundtable and the U.S. Chamber of Commerce. The managers of corporate America, it seems, don't want their owners to muck around in what are, in truth, their affairs—the governance of the corporation. Sadly, the largest and potentially most powerful private retirement plans and mutual fund managers couldn't seem to care less. It is high time that the private sector joined its public and union counterparts and demand a voice in corporate affairs.

Yet while private managers seem little interested in assuming either the rights or responsibilities of corporate ownership, public and union managers, I fear, have sought to exercise their rights while failing to give adequate consideration to their responsibilities. It may be, as it is said, that "Bad cases make bad law," but I believe that the actions of a small group of public retirement plans and union funds are jeopardizing even the grudging reforms toward corporate democracy that are now on the table.

A Democracy or a Republic?

Henry G. Manne, dean emeritus of George Mason University School of Law puts the case harshly, describing corporate democracy as "a form of corporate fraud," and describing you as "special pleaders with no real stake, activists (whose) primary interest . . . is to facilitate publicity for their own special programs . . . and to interfere with the property and contractual rights of others to achieve their own ends." Some of what I would describe as the "bad cases" that give unwarranted credence to Dean Manne's thesis include:

- Calpers' withholding of support for the CEO of Safeway, portrayed in the press (I do not have the facts) as "retaliation against management after a bruising strike."
- The position taken by Institutional Shareholder Services (and Calpers), against Warren Buffett's re-election to the Coca-Cola board. Logical as that position may be as a matter of sound *process*, it seems to me, knowing Mr. Buffett personally and aware of his firm's long-time ownership of eight percent of Coke's shares, that it fails the test of sound *judgment.*
- The recent pressure by some state and union funds to lobby against making private accounts available through our Social Security System. Using pension fund business to achieve a political goal, good idea or bad, is simply inappropriate. What is more, it is counterproductive to the achievement of our goal to actively participate in corporate governance.

I believe that some introspection on the part of the CII membership would suggest not only that these specific kinds of special interest proposals have no chance of success, but in fact give the Henry

Mannes of the world—and, dare I say, *The Wall Street Journal*—extra ammunition to fight off the ultimate arrival of corporate democracy. As I was reminded in my youth, there is no use in cutting off one's nose to spite one's face. While the conflicts of interest and the agendas may differ between public and union plans on the one hand, and private plans and mutual funds on the other, it seems to me that it might be useful to have each group critique the other's handling of their very different—but very real—conflicts, and reason together about joining forces to put forward policy positions on corporate governance issue where the only—the *only*—issue is what is best for the shareholders of the corporation as a group.

Let me sum up: We have entered a new era of institutionalization in securities ownership. It is without precedent; it is important that we get it right. But it is *not* an "ownership society." What we have, in fact, is an "intermediation society"—or maybe an "agency society,"—descriptions that, while neither catchy nor inspirational, are far more accurate. But whatever we call it, it's not going to go away, ever. All of us are not *owners*, but *agents* of the owners. Perhaps after all, it is not pure "democracy" that the shareholders of corporate America need, but the kind of corporate "republic" that Plato described two-and-a-half millennia ago.

But whatever we call the system of stockholding that we have today, our vast public, private, and federal retirement systems *must* be, well, "organized, operated, and managed" for the ultimate beneficiaries, those human beings who have entrusted us with the solemn responsibility of serving solely their interests—not merely an intermediation society, not merely an agency society, but of all things, a *fiduciary society*.

Note: The opinions expressed in this speech do not necessarily represent the views of Vanguard's present management.