SRI in the Rockies
October 19-21, 2003
Lake Tahoe
Squaw Valley, CA

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SHAREHOLDER SOCIAL ACTIVISM
Learn from our mistakes

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The sincere efforts of many dedicated people in aid of shareholder activism and social investing have been significantly counter productive. We must learn from our mistakes. Our cause is just; we need better discipline.

Social investors and shareholder activists have acted like two of the proverbial blind men trying by feel to describe an elephant on first encounter. Each has detected elements of ultimate truth, but both have misinterpreted the relative importance of their perceptions. This metaphor is more than usually apt because the true nature of the "beast" is so much larger and more complicated than any of the blind men could have imagined. We cannot get an answer from the market place. "Market theory holds that creating private property rights gives people indispensable incentives to produce new wealth…. It turns out that the much vaunted 'efficiency' of material self-interest, as advanced through property rights, is often an illusion because the market/property/contracts framework structurally ignores the significant externalized costs it displaces onto other people and nature."[i] The market can only reflect information that is available.

In order to enable productive involvement of shareholders, we need to consider certain strands of error that inform current dialogue about ownership involvement.

1. Social Investing insists on corporate change without addressing the fundamental question - Who sets the standards? There are so many voices, ranging from the United Nations, the Kyoto signatories, an infinity of non governmental organizations ('NGOs'), universities and consultants all insisting that their formulation of the problem and their recommended solutions are correct – and are the only ones that are correct. How can all these constituencies be harmonized, and who is going to decide who is correct? We cannot very well lead a movement and we cannot enlist corporate allies effectively unless we can articulate clearly and consistently what are the goals.

It is sometimes lost sight of that no one of the prestigious advocate groups has authority to promulgate rules which will legitimately define the scope of permissible corporate conduct. Only, government can set binding rules. That is where the problem begins. No American can think that the government's rules respecting permissible emissions from automobiles, for example, represents much other than the power of corporations to dominate the law making and enforcing process. The government's recent interference in the Environmental Protection Agency's report on Global Warming is evidence of excessive industry influence: "The editing eliminated references to many studies concluding that warming is at least partly caused by rising concentrations of smokestack and tail-pipe emissions and could threaten health and ecosystems… In its place, administration officials added a reference to a new study, partly financed by the American Petroleum Institute, questioning that conclusion."[ii]

Legitimate government rules must be based on an informed and uncoerced process. Corporations must disclose all relevant information about the impact of their functioning on society in the realms where legislation is contemplated. There are a number of international

efforts to develop standard reporting criteria for particular industries. It will take time to harmonize the practices in different countries and to find a way of dealing with corporate entitlement to protection of proprietary “intellectual property”. Corporations must maintain open communication with law makers and law enforcers, but the relationship need be characterized by restraint. It is in corporations’ interest that governments promulgate appropriate laws and regulations concerning their operations, if, for no other reason, so as to assure that their competitors will have to live by the same rules. Having a single set of rules simplifies the problems both of monitoring and of compliance. Lord John Browne undertook for British Petroleum to cease political contributions of all kinds all over the world. Business cannot prostrate itself before other competitors for government largesse, but, as the largest source of political financing, corporations are in a position to negotiate the diminution of all institutional money in politics. The owners of corporations can, and should, insist that ***their*** companies follow this litany.

The language of insistence by shareholder activists creates its own problems. We need a language with which owners can communicate with Chief Executive Officers in a mutually supportive dialogue. The kind of corporate leadership necessary for legitimate legal standards will only be manifest to the extent that corporate officers are fully participants. One cannot force corporate leadership.

At the end, there is need for a new language or process by which corporations can share information about such problems as Global Warming with appropriate governmental authorities in aid of legitimate informed regulation.

2. Shareholder activists have focused their attention on the short term measurable consequences of corporate functioning; social activists speak of the long term. This does not mean that either of them is stupid or insensitive, but the consequences are that natural allies seem to be talking past each other. An unfortunate consequence of this “terminology dilemma” is the apparent “mixed message” that ownership sends to management. CEOs can hardly be blamed for being confused by one class of owner who demands current results and another that asks for focus on the longer term.

Once and for all we have to “bell the cow” of short term / long term confusion. The distinguished scholar Margaret Blair has recently clarified this needless and destructive debate. “…[A] number of prominent advocates for shareholder primacy have retreated to the position that directors and officers should attempt to maximize long run share value performance, rather than short term values. But the mantra of share value maximization has no distinctive meaning and policy implications if it is not interpreted to mean maximization of short term values. This is because the actions required to maximize share value in the long run are indistinguishable in practice from actions taken in pursuit of other more broadly stated goals such as maximization of wealth for all corporate stakeholders.”[iii] The use of “long term” has enabled sloppy thinking. A far more useful concept is “holism” – we need an accounting language that reflects the full present impact of corporate functioning.

There is such a general discontent with Generally Accepted Accounting Principles that the timing seems favorable for expanding traditional concerns. It is, alas, easier to know that something is wrong than to prescribe an immediately acceptable new formulation. Such scholars as Baruch Lev have given us imaginative and practical suggestions for taking into account such intangibles as “intellectual property”; we need to begin the process of putting a price on the cost of externalities involved in corporate functioning. Until we commit ourselves to taking into account the “true cost” of corporations, we condemn ourselves to exacerbation of current problems because the market pricing will encourage socially harmful conduct.

Matthew Kiernan puts this particularly well: “Our ultimate purpose is reengineering the DNA of Wall Street. The fairly simple-minded strategy is that, if you want to change corporate behavior, you have to start with their financial oxygen supply, producing solid information from social-environmental areas that have been completely opaque to financial markets. While the Wall

Street crowd looks at people like us as woolly-minded, I would argue that the apparent sophistication of their analysis is pretty spurious, since most of it comes from accounting-based numbers that are completely unreliable. Depending on who's doing the accounting, a company either made $300 million last year or lost $300 million. If financial markets can see that these environmental and social issues matter to them financially, if they have good information they can rely on, then the markets are pretty good at punishing and rewarding. So we are really increasing the transparency levels of corporation with the objective of using the financial markets as an engine of reform and positive change rather than destruction."[iv]

3. While there is some measure of agreement that corporations are to be run for the benefit of their shareholders, there is amazingly little focus on what this really means. Literally, "shareholder" can mean the tiniest scintilla of ownership involvement; it can also mean permanent ownership. There are shareholders whose interests are the blip on a computer program; arbitrageurs are "in and out" several times a day; mutual funds trade with reference to periodic taxes, and so forth. The largest category of owner is the pension system and its largest component is the defined benefit plan. Pensioners typically have eighteen years of work before retirement so their trustees should have a long term viewpoint. We should be clear that the "shareholder" for whose benefit corporate officers manage business is the some twenty percent of their holders, who have interests in defined benefit pension plans. The scope of management duty can be made specific when the identity of the person to whom they owe fiduciary stewardship is identified. It is hugely important that this be a "flesh and blood" person and not a theoretical construct.

There has evolved the so-called "index" mode of investment through which a purchaser acquires an interest in whatever category of securities they choose. The index will always hold those particular securities, so the ownership term is, for all intents and purposes, perpetual. The percentage of the total outstanding market that is "indexed" cannot be accurately determined, but it is certainly more than ten percent and probably less than twenty. There exists, therefore, a substantial class of long term and permanent equity owners.

It seems counter intuitive to look to mechanically assembled bundles of equity security for an activist energy or a concern for the impact of the functioning of portfolio companies. However, the index funds are a niche product competing for the investors' attention. They have a unique interest in assuring that equity markets are the most attractive investment mode for generating value in the future. To the extent that corporations are associated with environmentally careless policies, over time the market will assign lower values to their shares. This will tend to make other modes of investment more competitive – like, today, "private equity".

4. National governments do not have authority that is congruent with borderless corporate activity. Modern corporations have world wide operations; nation states' jurisdiction is geographically limited. International organizations do not, generally in the area of the environment, have authority to promulgate and enforce rules respecting corporations. Businesses can choose legal domicile wherever it seems of greatest advantage. There is great flexibility in choosing which operations should be subject to the jurisdiction of which country. No country has complete authority or ability to regulate the full scope of a multi national corporation's functioning. There is great competition among countries to attract corporations – with their jobs and tax revenue producing operations. This inevitably ends in a "race to the bottom" as countries compete to attract business. Most countries have strong traditions of government hegemony over business. Indeed, in most countries until recent times the government has been the owner and operator of many of the basic industries. Only the United States has inveterate and largely unchanging traditions of aversion towards government involvement in business. But, the United States is the dominant business culture in the world today.

Because countries are not able effectively to pass laws in areas having global impact, there has been a tendency towards international treaties. The Kyoto Accord was the UN's initiative to provide a global solution in areas relating to global warming. Countries are largely free to decide

whether or not they will be bound by such international accords. The United States famously has usually declined to be bound – whether it was the Law of the Sea under President Reagan or the Kyoto Accord under George W. Bush. There is, therefore, no authority from outside that effectively limits corporate conduct.

There has emerged the phenomenon of The New Global Investor. Pension funds from the US, UK, the Netherlands and other Anglophone countries are not merely the largest shareholders of companies in their own countries, but in all the other countries of the world having public markets. "[N]ot all shareholders need to be activist. Some owners may participate meaningfully in equity risk/reward through indexes or other non-voting arrangements – so long as there exists somewhere in the corporate constellation an informed and effective nucleus of participating owners. The significant percentage that pension funds own in corporations worldwide suggests that they will be able to rise to this challenge."[v] We can look to effective monitoring of corporate environmental policies and practices from *within* its governance structure.

5. Over the decades of increasing attention to the role of owners, an ugly truth insists. Activists comprise a relatively small and polarized portion of all institutional shareholders. This pattern is most clearly established in the United States, but it is also apparent in the United Kingdom and continental Europe.

The State of California (CalPERS) and the City of New York (NYCERS) pension funds really have been the only consistently committed long term activist institutions in the U.S. At times, the College Retirement Equity Fund (CREF) has been usefully active and other state funds have periodically been involved anecdotally. There has been virtually no involvement by foundations or university endowments – no Harvard, no Ford Foundation. There has been no involvement by private company pension schemes subject to ERISA – no GE or IBM pension fund. The same pattern prevails in the United Kingdom with the honorable exception of Hermes, which is the only private institution in the world not only willing, but profitably proud, to associate itself with the agenda of ownership responsibility. USS has become a formidable figure in the world of social investing, and many local funds – under the leadership of PIRC – have been effective activists. But the problem remains the same as across the ocean – Where are the Great and the Good? Where is Cambridge University; where is the Wellcome Trust? Elsewhere in the world, there are controlling shareholders of most public companies and the question of activism depends on the particular owner's predisposition. In sum, the activists are government pension funds of which the trustees are elected officials and the agents are civil servants, not cadres experienced in or sympathetic towards business goals. Our most pressing problem is - How can this "beachhead" of institutional activists be transformed into a credible foundation for ownership based corporate governance. Unhappily, the portion of the spectrum represented by public pension funds is very slender and this encourages trivialization of their efforts. In order for ownership based governance to have credibility, there will be need for participation by a broad base of institutional owners. Specifically, there will have to be involvement by the leading universities and foundations. It is essential that private company pension funds not only participate, they must be in the leadership, because they have access to far more expertise and experience than any other shareholders.

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 a holistic concept of 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 enforcement of existing laws.

The Myners report in the UK is the clearest possible statement of the need for institutional involvement in corporate governance. Enforcement of Myners has been uneven. This contrasts favorably, however, with the situation in the United States where the Department of Labor has simply failed to enforce the provisions of ERISA that require plan fiduciaries to administer portfolio investments **for the exclusive benefit of plan participants.** Instead the financial conglomerates decline to act out of consideration for their own business success. Currently, the General Accounting Office is looking into the twenty year failure of the Department of Labor with specific reference to the voting in the hotly contested Hewlett Packard / Compaq merger case of April 2002. The SEC in late August 2003 found violation by the institutional investor – Deutsche Asset Management – on grounds that are not only violation of securities laws, but also prima facie violations of ERISA. Hopefully, the Department of Labor’s deficiencies will be tolerated no longer. Possibly, their enforcement responsibility will be transferred to another agency like the SEC. This may create an atmosphere of full ownership involvement in corporate governance.

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 both that 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.

Only shareholders can give management authority to base corporate resource allocation on an holistic basis. It can be said, with justification, that there is no process that can predict the future with a tolerable level of risk – long term strategy involves the certainty of losses. Managers cannot volitionally expose owners to needless loss; they cannot, of their own motion, adopt a mode with greater chance of loss. Shareholders have unique authority to enable a risk policy congenial to their own priorities.

The mission is to increase high level consciousness that social objectives can effectively be addressed through shareholder based corporate governance. The challenge comes in structuring the decision making and accountability process. If the challenge is met, corporations, assured that their competitors are being held to the same standards, will not ultimately be threatened; institutional investors, with a perspective congruent with that of environmentalists, will embrace pursuit of long term value; government, focused on enforcing existing laws and participating in setting standards, will function in its intended role. The challenge is to make leaders – political, corporate and institutional owners - understand that this difficult problem can be “solved” on a win/win basis?

6. There is no body in the corporate or regulatory constellations that is vitally concerned with the need for an holistic view of corporations. Bonuses must be earned, pensions must vest, elections must be waged – all of the relevant time frames are less than ten years. Energy company investments have maybe a twenty term between the commencement of construction

and full pay back of the investment at acceptable rates. Concerns such as Global Warming need be thought about in terms of fifty years or more. This will not happen unless a dedicated and empowered corporate body is created to initiate and to monitor. As we have earlier discussed, institutional shareholders with a long term perspective now have a controlling interest in the largest Anglophone companies and strong interest in all others.

We cannot expect even the most altruistic institutional shareholders forever to defy the economics of “collective action” and carry the “free riding” passive shareholders. If effective shareholder involvement is essential to healthy corporate functioning, there must be developed a mechanism to reward – or, at least, to cease penalizing those who are willing to take action.

A new and special shareholder committee empowered to represent holistic considerations should be directly elected annually by the shareholders.[vi] We have no choice but to make institutional provision for the effective representation of “ownership” interests within the corporate constellation.

ENDNOTES

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[i] Clippinger & Bellier, Renaissance of the Commons.

[ii] Andrew Revkin and Katharine Seelye, Report by the E.P.A. Leaves Out Data on Climate Change, *New York Times*, June 19 , 2003

[iii] Margaret Blair, Abstract, Directors’ Duties in a Post-Enron World – Why Language Matters”, Wake Forest Law Review, Vol 38, Fall 2003.

[iv] The Soul of Capitalism, p 119.

[v] Robert Monks, New Global Investors, p 177.

[vi] I introduced a model for this at the 1992 Annual Meeting of Exxon. A copy is attached [Exhibit A]