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Shareholders: Part of the Solution or Part of the Problem?

As we now know all too well, the credit crisis and the global recession stemmed, in important part, from stark failures of boards of directors and operating business leadership in important financial institutions: the witch's brew of leverage, poor risk management, creation of toxic products, lack of liquidity---all made more poisonous by compensation systems which rewarded short-term revenues/profits without regard to risk.

Buffeted by the recession and the seizing up of the credit markets, GM and Chrysler veered into bankruptcy, burdened by decades of questionable decisions.

As a result of these dramatic collapses in both the financial and industrial sectors, trust in corporate leaders---indeed in the ability of corporations to govern themselves---has eroded dramatically (even though there are, of course, well run corporations in both areas of the economy). This crisis in confidence, due to problems real or perceived, has spawned numerous public sector initiatives, both here and abroad, to impose new limits on private sector governance and self-determination.

In the financial sector, the regulatory debate is robust. It has focused on imposing direct, substantive government rules limiting private sector discretion: e.g. counter-cyclical capital requirements, liquidity protections, revised accounting standards, credit rating agency reform, regulatory review of executive compensation, regulatory approval of certain complex products, better consumer protection, assessment of systemic risk, and special oversight for large complex financial institutions.

But for all publicly held corporations, financial and industrial, a dominant, recurring theme has been to "improve" the process of corporate governance by mandating an enhanced role for shareholders as a check on boards of directors and business leadership.

But a fundamental, recurring question needs to be asked and answered: are "shareholders" part of

the solution or part of the problem in this governance crisis of confidence ?

• One public policy initiative is to give shareholders more "voice," primarily through advisory votes at annual meetings on the executive compensation regimes approved by the boards of directors ("say on pay"). This would mandate uniform federal "process" in an area of the law historically governed by the states and by shareholder efforts, company-by-company, to secure the right have such "say on pay" votes.

• A second regulatory change would increase the ability of small groups of shareholders to nominate alternative candidates in the annual shareholder election of directors ("ballot access"). Today, shareholders customarily vote for slates of directors nominated by the directors themselves---and it is expensive and cumbersome for shareholders to field additional candidates. (Of course, powerful economic interests can buy large blocks of stock and force directors onto boards or launch a hostile takeover for the whole company.)

These are "hot" shareholder issues. Both the Obama Administration and the Congress support "say on pay" shareholder votes for all publicly held corporations in the U.S. . And the SEC, which has debated the subject for years, now has a Democratic majority to approve some version of a "ballot access" rule.

The problem: the easy assumption about "shareholder" as "solution" ignores some obvious issues which have gained force in recent years.

• There is no such animal as "the" shareholder. Instead there is an extraordinary menagerie: large and small individual investors; public and private pension funds; a wide array of mutual funds; endowment funds for educational, health and other non-profit institutions; and an equally wide array of hedge funds. Almost all these institutional shareholders are trying, in one way or another, to beat their "benchmarks" whether those are the Dow Jones or the NASDAQ or relevant S&P or MSCI indexes or to make annual, absolute profits for themselves to justify the fees charged clients (including the two percent fee and 20 percent of profits often required by hedge funds).

• Institutional investors now own approximately 60 percent of U.S. equities (using other people's money). Many observers say, while there are some long-term value holders, many of these investors are driven by the goal of short-term performance in their portfolios, engage in relatively short-term trading strategies and have little interest in corporate creation of long-term economic value by the corporations whose securities they own and trade. (Shares of stock are now held, on average, for far shorter periods than was the case 10 or 20 years ago.)

• Indeed, important questions have been raised about the role institutional investors played in causing the melt-down by pressuring financial service entities to take undue risk for short-term profits., Did the short-term investors crowd out long-term value investors in influencing

corporations, and, if so, is this likely to be the future pattern?

• Questions have have also been raised about what kinds of salary and bonus plans do the institutional investors provide to their fund managers---the people who drive the stock market and may be an important source of the short-term pressure on companies? And, how are powerful institutional investors--from pension to mutual to hedge funds--- governed and what are their fiduciary duties to individuals whose money they "manage."?

• Ultimately, how imperfect are shareholders and the stock market in valuing companies given the widely divergent time frames and objectives of institutional investors and the irrationalities (e.g. herd mentality) and inefficiencies of the market at any moment in time?

As Henry Kaufman, a prominent Wall Street economist for decades has written in a recent book (The Road to Financial Reformation), most "investment relationships today are very fickle. Portfolio performance is measured over very short time horizons...Day trades and portfolio shifts based on the price momentum of the stock---rather than anything having to do with the underlying fundamentals---are commonplace."

Or, as Ira Millstein, a godfather of the corporate governance movement and long-time advocate of more shareholder voice, has recently written (in Directorship magazine): "...the model of shareholder activism...envisioned in the 1980s and 1990s [is] under severe strain. Institutional investors were once presumed to share a common goal when exerting pressure on boards to monitor management and effectively guide firm strategy. That assumed homogeneity is long gone...The diversity of shareowners has brought a whole new host of agendas, strategies and values to the table. Some of these owners have limited investment horizons and are only interested in realizing a short-term profit, and others have hedged or shorted their positions and consequently have a financial interest in the failure of the enterprise."

Non-US regulatory bodies like the multinational Financial Stability Board or the UK's Financial Services Authority in their lengthy post-mortems on the financial crisis have analyzed the harmful effects of investor short-termism. And when the Federal Reserve Board recently announced that it would supervise, and if necessary regulate, executive compensation at the nations banks, its proposed rule noted that a shareholder perspective was inadequate: "Thus a review of incentive compensation arrangements and related corporate governance practices [as through "say on pay" votes] to ensure that they are effective from the standpoint of shareholders is not sufficient to ensure they adequately protect the safety and soundness of the organization."

In fact, there is now a growing movement to examine the institutional shareholders critically and systematically as a cause of the short-termism that drives bad corporate behavior (the Millstein Center for Corporate Governance and Performance at Yale's School of Management and Aspen Institute Business and Society Program come to mind). The important issues noted above need

systematic empirical and prescriptive exploration.

Seen through the lense of history, this is, in fact, just the latest chapter in an historic argument about the respective powers of shareholders, boards and management to control corporations (within the context of legal rules and regulations). Shareholders "own" the company and elect the directors, but often in the past there was no real electoral competition because the only candidates were those selected by the board itself, with heavy CEO influence, and management had a monopoly on important information. A famous book by Adolf Berle,Jr. and Gardiner Means in 1932 described this separation of "ownership" and "control" (The Modern Corporation and Private Property). Game on---for more than 75 years.

To be sure, those advocating a bigger role for shareholders are addressing real and important issues.

• Companies should consult shareholders, but not just on pay in a formal annual meeting vote. More importantly, corporate directors, CEO's and senior business leaders need to give all stakeholders "voice", not just shareholders: creditors, employees, customers, suppliers, communities. All are critical to the health of the corporation; all come in different shapes and sizes; all have important, but divergent interests. Company leadership must hear and balance all these concerns in reaching a decision about how to carry out the corporation's fundamental mission. But how many listen well?

• Shareholders have also raised the profound issue of board and CEO "accountability." The problem, as noted, is the self-perpetuating nature of corporate power, CEOs suggesting board members, board members nominating each other for routine shareholder election. If the company leadership is complacent or making bad decisions, how fix the problem. (GM?) The broad answers have their own issues. Regulation can be too heavy handed, have unintended consequences and stifle creativity and innovation (especially regulation about governance in contrast to laws protecting a social good like the environment). Turning corporations into political entities with blocs of shareholders fighting continuously about control and direction would sap precious time from providing great services. And the stock market may in the long run value companies correctly but in the short run be irrational and punish companies for taking actions for long term growth (investments, R&D) that depress profits in short term.

The ultimate question which underlies virtually all of the regulatory debates is: "voice" and "accountability" in the service of what mission? Many would argue that the dominant mission of the past two decades of creating shareholder value is too narrow and too prone to short-termism. Many market participants (and we need much more study to understand precisely) are not interested in what most would argue is the the basic task of corporations: to create sustainable economic value by providing great goods and services which customers want and which benefits all stakeholders using sound risk management and with high integrity (law, ethics, values).

Put a slightly different way, boards and CEOs must balance risk taking (innovation and creativity) with risk management (financial and operational discipline) and must fuse high performance with high integrity (to address legal, ethical, reputational, policy risk). Carrying out this mission by defining and attaining key operational goals in performance, risk and integrity dimensions---and compensating according to those goals-- is the fundamental role of boards of directors and senior management. This what creates long-term shareholder value.

In light of the deleterious focus of many institutional shareholders on short-term results in their own, not the corporation's interest, we need to understand in a much clearer way when shareholders can be part of the solution---and when they are a major part of the problem---in advancing that fundamental corporate mission. But the deeper problem is finding the right accountability mechanisms which allow the right measure of corporate self-determination at the board/CEO level but which also holds them to account.

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