Shareholder Activism **Fall 2009**
Lucian Bebchuk and **Harvard Law School**
Beth Young

Session 14: The Past, Present, and Future of Shareholder Activism:
Bob Monks' Perspective

Readings:

- Robert A.G. Monks, "Corporate Governance – Past, Present and Future," November 10, 2009.
- Letter from Robert A.G. Monks to Lucian Bebchuk, September 30, 2009.
- Robert A.G. Monks, "The Return of the Shareholder."
- Biography of Robert A.G. Monks.

NOTE: These materials are assigned for the session on Tuesday, November 10. Bob Monks will be present to discuss the subject. Submitted memos should include two comments, one on the materials and one on Monks' comments during the session. The memo is due by noon on Monday, November 16.

CORPORATE GOVERNANCE – PAST, PRESENT AND FUTURE

Robert A.G. Monks
November 10, 2009

Francis Fukuyama published “The End of History” in 1992, styling the fall of the Berlin wall as the termination of a long period of competitive ideologies and nations. There appeared from this half millennium evolution an unending and global accord of political democracy and market based capitalism. Over the following fifteen years, particularly in the United States, the values of the market prevailed under the rubrique Globalization which provided a measurement language based on maximization of transactions. Market power, incarnated in the transnational corporations, increased its influence over competing considerations to the point in the Bush Administration where it was virtually the only voice, with disastrous results. Cost / benefit calculations, which excluded consideration of externalized liabilities, were skewed changing both the persona of corporations and the character of those who served them.

The prevailing theory has been that a co-operative interrelationship between involved owners, fiduciary directors and government would provide sustainable standards and effective implementation. Within this framework, we have all been involved in the struggle to affect, influence, reform “market place” values. What we had thought was a global harmony of democracy and the market places turns out to have been merely a new iteration of the struggle for power with its traditional characteristics of concentrated wealth and public poverty. Alan Greenspan has becomingly acknowledged his failed philosophy - "I made a mistake in presuming that the self-interests of organizations, specifically banks and others, were such that they were best capable of protecting their own shareholders and their equity in the firms." And so, the dream of the private participants in wealth creation managing their affairs to accommodate public welfare has failed.

We have now come to the End of the End of History.

The prolix Judge Richard Posner illumines: "but although the financiers bear the primary *responsibility* for the depression, I do not think they can be *blamed* for it – implying moral censure – any more than one can blame a lion for eating a zebra. Capitalism is Darwinian. Businessmen take risks (mostly within the law) the promote their financial interests; it would make no more sense for an individual businessman to worry that because of the instability of the banking industry his decisions and those of his competitors might trigger a depression than for a lion to spare a zebra out of concern that lions are eating zebras faster than zebras can reproduce"[1]

The irresponsible use of power by Chief Executive Officers is the primary cause of failure of a private corporate governance regime. Can they be blamed for asserting power to control the board to which they are nominally accountable, dominating the process by which their compensation is determined, the accounting rules by which their performance is evaluated and using corporate resources to prevail in government debate over resource allocation in a "free" society? No matter the private morality of the cadre of corporate directors, no board generated by a self perpetuating process can achieve the objectives fixed by statute or by the demands for a private system of effective governance. Three quarters of registered shareholders are fiduciary institutions. Since 1975 fiduciaries have been permitted to have public owners and transferable interests, thus locking in a conflict of interest causing the trustee to prefer the economic fate of its own shareholders rather than the beneficiaries for whom it is responsible. Indispensible to the collapse of private governance has been the failure of government at all levels – executive, agency and judicial - to enforce existing laws, importing including those prohibiting just the conflicts of interest that have crippled ownership.

Corporations are about creating wealth in a manner satisfactory to the requirements of the chartering domicile. This started with Royal Charters and special charters for specific public works. Overtime, the definition of public interest was diluted to the point of mere recitation. In different countries, the relationships between corporation and state, wealth and public authority are expressed differently under changing conditions. But, the

[1] Posner, Richard, A Failure of Capitalism, (Harvard 2009) at p. 284

legitimacy of corporate power depends on the perception and reality of the the independence and hegemony of governmental authority. In the United States, the geometrically increasing levels of lobbying and corporate expenditure in political elections challenge any notion of legitimacy. The notion that artificial legal entities organized to facilitate the transaction of business and the accumulation of wealth should have constitutionally protected rights that the Framers believed came to human beings from their Creator has even less credibility today than in 1978. Certainly the amorality of corporate America has only become clearer since Justice Powell gave corporations political rights. In most other countries, the superior power of the state is acknowledged, but one needs examine the specific circumstances to decide whether the state has become the creature of the financial interests. Certainly, the experience of the US and the UK "too big to fail" financial sector evidences just this phenomena. The state has, in effect, been held hostage by the self inflicted wounds of a few prominent companies.

Corporate governance in all countries is based on the division of power and responsibility between public and private authorities. Elected authority has full power with respect to proscribing standards with which private entities are obliged to comply. Private wealth creation is deemed to be in the public interest so long as corporations obey the law, inform the public about the corporation's impact on society and minimize corporate involvement in politics. This theoretical triad actually forms an interrelated and self-reinforcing conceptual basis for corporate accountability and legitimacy. In different countries at different times, there are departures in practice from the necessary elements of a legitimating structure. Corporate governance based on relationships between owners, directors and managers is not the pattern which will prevail under circumstances, like those prevailing today, in which there is significant direct government involvement as owner and creditor.

There is vast agreement that Corporate Governance failures are responsible in large measure for the financial disasters of the last several years. Consider from the UK. "The Treasury Committee Report provides an answer in the affirmative. . "Institutional Investors have failed in one of their core tasks, namely the effective scrutiny and monitoring the

decisions of boards and executive management in the banking sector, and hold them accountable for their performance." [2]

Five years ago, in addressing this class, I made suggestions as to ameliorate the governance deficiencies of shareholders, directors and executive officers. The context has changed – we are no longer talking of a voluntary rearrangement of the prerogatives of components of the corporate structure, we will be confronted by specific new governmental regulations – the scope of which is still unclear. We have learned how expensive dysfunctional governance is. We must learn from our mistakes, not just repeat them.

We can no longer blindly accept the received wisdom as to the roles and responsibilities of owners, directors and CEOs. Categories simply do not perform as advertised. While there is general understanding of this, proposed remedies have persisted in dealing with these classes, as if their traditional categorization was real. We need to express clearly how each has functioned during this crisis period, how that functioning departs from the "conventional wisdom" and what remedial steps can be taken. It is naïve to think and act as if the current arrangement of power is not satisfactory to many who hold it. Our efforts will be a struggle for reallocation of that power.

The vast majority of institutional owners today decline to be responsible for the functioning of companies whose shares are held in portfolios, for the management of which they have fiduciary obligation. In the case of banks, mutual and pension funds, the explanation is conflict of interest. In the case of universities and foundations, it is a bit more subtle - there is a disinclination to disturb existing profitable relationships.

The core problem has been the disappearance of any practical or legal respect for the fiduciary standards that ensure a beneficiary of the loyal competence of the person responsible for managing his property. We have tolerated conflicts of interest throughout the commercial system with the result of enriching service providers and impoverishing

[2] House of Commons, Treasury Committee, Banking Crisis: Reforming corporate governance and pay in the City, 12 May 2009 # 179.

beneficiaries. Worse, this regulatory neglect has placed the conscientious fiduciary at a competitive disadvantage.

We arrive at the current place where "activism" is not generally attractive, either from the perspective of value adding incentive or of avoiding discipline or fine for fiduciary failure.[3] Simply, the "carrot" is not sufficient inducement and the "stick" is insufficiently daunting. The result is that – with a few honorable exceptions -TIAA/CREF in America, BTPS and Hermes in the UK – activism has been limited to union and public employee pension funds, which – notwithstanding their virtues – do not appear to have the experience or orientation necessary to act as credible maximizers of shareholder value. In sum, only the least credible tranche of shareholdings are prepared to act for the class as a whole; the preponderance – for their own reasons – prefers non action.

This systemic dysfunction necessitates the involvement of an external catalyst – government. Only government can definitively locate the responsibilities of shareholders – shares loaned, shares sold short, shares whose vote is contracted away from the economic beneficiary, and – not least – Government as shareholder – UKFI. There is need clearly to place responsibility for stewardship on one of the parties in the fiduciary chain. The pattern of trustees delegating functions is well established; often the voting responsibility is de facto delegated to a voting service. If active ownership is to serve its intended purpose, there needs be a single responsible body. Nor can a US or UK regime bind institutions with domiciles elsewhere. As the Walker report duly notes, a voting regime can only be imposed on UK domiciled funds. "The aim is to embed commitment to the Principles of stewardship (on a "comply or explain" basis) on the part of UK-authorized entities and thereafter to encourage voluntary participation by SWFs and other non-resident investors on the basis that this is likely be in their own interest and in that of their clients as ultimate beneficiaries." {5.40}

[3] An honorable exception is the late Alastair Ross Goobey, who, while CEO of Hermes Investment Management, devised a business scheme pursuant to which those to whom he was responsible were enriched at the same time as his subsidiary activist funds, initially Hermes Lens Asset Management, introduced activism into the UK market place. His view was that index investors have no choice but to allocate assets to assuring the continuing integrity of the market place in which they invested.

Short term activists – arbitrageurs, "locusts", hedge funds – need no encouragement. Their business model rewards thrusts into the market place. We are left with two components of potential long term activists – the unthinking index and computer shareholders and the activist portion of McKinsey's "intrinsic" holders. They have very different characteristics. The index funds are in competition with active managers for the portion of investors funds allocated to equity. One of the principal competitive advantages they have is lower costs. If the index funds are to be an element in the activist shareholder of the future, some economic arrangement will be necessary in order not to prejudice their competitive posture. Their perspective will inevitably be systemic. Following the guidance of Alastair Ross Goobey, they will relate to the market place as a whole, they will not usually focus on individual companies. Alas, there is no clone of Alastair. We will need overcome present reluctance of indexers with carrot or stick. The intrinsic holders, by contrast, will focus on individual companies. Probably, their incentive structure always needs to be reconsidered. Do we want two kinds of activism? And if not, which one?

It must be clear that amidst the panoply of stock ownership, there is a difference of kind between those who invest through impersonal mechanism and those whose investments are a matter of sentient choice. Lord Myners suggestion of two classes of stock might well reflect this difference. A further dichotomy might be drawn between those shareholders – passive and active – who chose to function as stewards and those who do not. Again, dual classes of stock might be appropriate. It is well to remember that when Warren Buffett invests in marketable securities, he is usually able to secure a special classification that reflects the value added by his involvement. Nor has the dual class prevalent in Scandinavia lowered long term equity returns. Even American scholars comment favorably on such a notion: "Providing long-term shareholders a greater number of votes per share should become a permissible option."[4]

Further improvement would result from the determination that stewardship, being in the interest both of the corporation and of society, is appropriately an expense of the

[4] Lipton, Lorsch, Schumer's Shareholder Bill Misses the Mark, WSJ, 5/12/9

corporation. If a sum is to be made available for those willing to undertake the costs and exposure of stewardship, there would be reduced difficulty is enlisting the index funds to perform the key long term role. It might well be that this is the best answer, as what is wanted is both long term stewardship and a perspective for the investment world as a whole, in contrast to individual companies.

This paper asks the question:

- Is there genuine commitment to an ownership based governance system? [It must be said that no such commitment exists at present.] This commitment will need be made by government. If so

The paper suggests two main policy initiatives:

- There must be effective enforcement of existing law so as to <u>require</u> fiduciaries to take appropriate action to protect and enhance the value of portfolio securities, and
- There must be arrangement for financing "activism" either as an appropriate corporate expense or as a designated portion of the investment management fees.

Peter Drucker has long raised the question as to whether the current standard of board functioning is so unsatisfactory as to require structural change. - "Whenever an institution malfunctions as consistently as boards of directors have in nearly every major fiasco of the last forty or fifty years it is futile to blame men. It is the institution that malfunctions."[5] In the years subsequent to Drucker's characterization, the inability of any portion of the governance structure to deal effectively with holding top management to account - the "smoking gun" being executive compensation - compels the conclusion of continuing systemic board failure. If the shareholder cannot hold the CEO accountable for his compensation, he has no right to assume that he exercises effective accountability in any other area. Analysis of previous board malfunction is virtually overwhelmed by the insistence on yet larger majorities and more extensive definitions of "independent" - "At

[5] Drucker, Peter, "The Bored Board," in Towards the New Economy and Other Essays, (Harper & Roe, New York 1981), 110

present the consensus view as to corporate governance best practice is so dominant that it is difficult even to suggest that further empowerment of an independent monitoring board may not be the solution to the current round of corporate scandals and flagrant abuses. Nevertheless, after watching independence and empowerment ratcheted up and up and up for 30 years, our conclusion is that enough is now enough. It is time to recognize that other best practice models of corporate governance need to be evaluated….. The point is that by turning the corporate board into the 'monitor' of corporate management, we do not appear to have been able to stop the scandals and flagrant abuses, and we may well be losing the vision, advice, and competitive perceptiveness that a good board should be providing the CEO. Surely there must be better ways to deal with the consequences of the separation of ownership from control in the modern corporation. The time has come, we believe, to think outside the consensus box."[6]

Corporate America has opposed even a scintilla of suggestion that shareholders participate in the nomination of board candidates. Former SEC Chairman Donaldson's proposal for token shareholder involvement was so plainly unsusceptible of leading to the election of a director that one is bewildered by the violent rhetoric of opposition. The usual reason adduced for this vehemence is the essentiality of maintaining the confidentiality and collegiality of board functioning. Sherlock Holmes would look further, but we need not do so here.

Perhaps, it is time to recognize that a fundamental and irreconcilable conflict exists in the perception of what boards should do and how they should be constituted. Our efforts to achieve functionality within the context of the traditional single board can be understood as the metaphoric inability to square a circle. We cannot hope to make progress until - once and for all - we face up to the reality that a self selecting board cannot ever meet the very real needs for independence at critical points in the governance structure. At the risk of offending Aristotelian purists, let me attempt a syllogism:

[6] Ibid, at 78

Independent directors are essential to good governance;

Directors selected pursuant to a self selecting process cannot be considered in any meaningful way to be independent;

Therefore, good governance requires something other than a board of self selected directors.

The desired objective can be achieved through the enactment of a pre-emptive federal statute conferring on ten percent of voting shareholders the right to call a special meeting at which a majority acting can remove any or all of the directors with or without cause. (The UK model)

The contrasting realities are:

- Major shareholders can, without provoking undue controversy or potential legal exposure, agree that there should be change in a board of directors.[7] Substantially greater commitment and exposure is required to get agreement as to the particular individuals who should be proffered as replacements[8].
- Institutional shareholders have no particular competency to select individuals to serve as director in specific situations.[9] They can, however, readily acquire the capacity to evaluate board changes proposed by management.
- Change does not mortally challenge management who retain the power to nominate directors.[10] This continuing prerogative is importantly balanced when shareholders have non controversial power to remove directors.

[7] Institutional investors would as a matter of "due diligence" have an opinion as to whether change is necessary in a particular company; the process of identifying particular individuals to take the place of particular directors involves substantial time, legal exposure and expense.

[8] My annual fees of some $50,000 to file a "plain vanilla" §14 (a)(8) resolution with a hostile Exxon Mobil gives some hint as to the administrative complexities and legal costs of effecting a nomination filing under the various access proposals. Who, as a practical matter, is going to incur these expenses?

[9] As special counsel in the settlement of many shareholder litigations, I have had experience in selecting new directors. I have a lot of humility about my role. In the UK, over ten years with Hermes Lens Focus Fund and Governance for Owners, I witnessed the creative tension that exists between a credible shareholder and management in the selection of particular directors.

[10] Outsiders cannot have the necessary knowledge of the chemistry and experience of the board, so as to be able to make optimal suggestion as to desirable changes in the composition of a board. Empowered shareholders can require management to justify their recommendations.

- A creative tension exists – management must ultimately propose nominees satisfactory to the shareholders who can effectively express opposition without undue exposure. This impresses as the right result.

If we have achieved the informed involvement of fully participating institutional investors in a governance system which empowers the accountability of directors to owners, there is little need to pursue specific limitations on the power of the principal executives.

ROBERT A. G. MONKS

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September 30, 2009

Professor Lucian Bebchuk
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Dear Lucian,

There is a better way of accomplishing the objective of making directors meaningfully accountable to owners than through the various proposals for shareholder access to the proxy.

My experience as a decidedly uninvited candidate for the Sears Board[i] taught that a confrontational mode of changing directors is intrinsically difficult – it evokes "knee jerk" hostility from the participants, it puts the regulators into an exposed position and it makes it difficult for fiduciary shareholders to deal honorably with their conflicted interests. Let me quote from the former chairman of Mellon Bank Frank Cahouet: "...We are very reticent to position ourselves as an activist shareholder in domestic or international securities. The problem for us is how we are perceived by our customer base. The risks are such that it probably does not make sense for us to take an aggressive position. I can imagine many of your partners do have a lot more freedom since they apparently have no other business interests with portfolio companies..." A reform proposal will not be successful in encouraging ownership participation if it puts conscientious fiduciaries at unacceptable risk. Preserving the essential rights of management and owners permits a system of orderly accountability.

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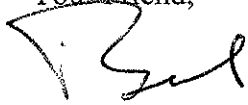
Your Friend,



Robert A.G. Monks

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[i] Hilary Rosenberg, Traitor to his class, Taking on Sears, 214-279.

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THE RETURN OF THE SHAREHOLDER

By Robert A. G. Monks

Less than two decades after Francis Fukuyama famously enshrined market-based liberal democracy as an optimal system at "the end of history,"[i] Barack Obama used his inaugural address to warn the nation that, "without a watchful eye, the market can spin out of control." The change in tenor from capitalist triumphalism to our current trepidation is indeed remarkable.

In these somber days, with corporate failures still grabbing headlines, the new President has inherited not only a severely weakened economy, but also executive leadership of a government that has already committed hundreds of billions of dollars recapitalizing the financial sector. With so much taxpayer money on the line, additional bailout requests piling up across the corporate landscape, and public anger still cresting, little wonder that the debate is now broadening to what kind of owner government should be. Will the large federal stake in banking, auto, and perhaps other industries prove blessing or burden? Onus or opportunity?

In fact, President Obama has signaled that he doesn't have much taste for his government's actively managing corporations. Immediately before his inaugural warning about the failures of unchecked capitalism, the President sounded almost Fukuyama-esque himself in declaring that there remains no question about the market's unmatched "power to generate wealth and expand freedom."

How then is the new administration to find a productive — but not meddlesome — federal role that neither relinquishes authority nor shirks its new responsibility as a major stakeholder? Finding such a position relies, I contend, on understanding the crucial role of corporate ownership in America's economic system: how it should ideally function, how it has actually existed, and what can be done to encourage its more perfect realization.

The Importance of Being Owners

"Weak, Ineffective Shareholding Root of Corporate Tumble" does not make an exciting headline. Yet while the daily dissection of our financial and commercial collapse

focuses on outrageous CEO compensation, questionable accounting, and other subjects more certain to raise a reader's blood pressure, a failure of ownership has been at its core. A CEO can pay himself at will only when the internal watchdogs – shareholders and directors – are not doing their job, just as an American president can consistently abuse his authority only by cowing Congress and the Supreme Court.

Imagine a set of scales in which informed ownership acts as a counterweight to the executives' otherwise unaccountable, value-destroying power. Without informed and empowered shareholders playing their part, the corporate system simply has no equilibrium. The Corporate Governance Council of the World Economic Foundation recognized that simple physical principle when it concluded that poor and weak governance was a major contributing factor to the recent massive destruction of shareholder value.

In a similar vein, the American corporation's productive coexistence with representative democracy depends on the balance provided by informed and active shareholders. When successful at keeping corporate management focused on profitable activity, owners insure that publicly traded businesses remain in the domain of strictly economic considerations, while everything else remains the province of government. This restraint serves both economic and social ends. For so long as corporations strictly limit their goals to economics, two intolerable problems are avoided: Investment returns will not be diluted through confusion of objectives, and political integrity will survive the co-existence of independent power.[ii]

That is the ideal: Enlightened ownership responsibly and actively exercised is a regulatory force far greater — and far less skewing of the markets — than intrusive government regulation can ever provide. However, as we have recently witnessed, the reverse of the ideal is equally true: Without such ownership, without a human-scale proxy for society, without an interested and entitled presence to which managements must account, the rationale for government not intervening in the private sector evaporates.

Engel's Triad and Eisenberg's Theory: Legitimating the American Corporate System

This notion of responsible ownership is critical to a corporate ethic outlined by former Stanford University law professor David Engel. Comprising three interconnected and reinforcing modes, "Engel's Triad" (the phrase is mine) calls for voluntary disclosure of information necessary for appropriate lawmaking, restraint in influencing the making and enforcement of law, and spacious compliance with the law.[iii] In this scheme, the principal responsibility for active shareholders is to assure ethical compliance, thus ensuring corporate functioning that is compatible with the public good.

Likewise, empowered ownership forms the first of Melvin Eisenberg's three creeds that legitimate the American corporate system: "The first is a belief that the shareholders, as the owners of the corporation, have the ultimate right to control it. The second is a belief that corporate managers are accountable for their performance. The third is a belief that placing control of the factors of production and distribution in the hands of privately appointed corporate managers, who are accountable for their performance and who act in the interest and are subject to the ultimate control of those who own the corporation, achieves a more efficient utilization of economic resources than that achievable under alternative economic systems." [iv]

Theorizations, of course, are just that: theory. Serious questions have long existed over whether the grand principles of shareholder ownership are more honored in the breach than in practice. Nearly 40 years ago, J.W. Hurst wrote, "The stockholder's legitimating role was probably never as the legend would have it."[v] Questions also surround the issue of whether shareholders, as opposed to employees and other stakeholders, are entitled to the central position in the corporate constellation.[vi]

It is also true that shares of stock are not the kind of property around which the legal, philosophical, and religious notions of ownership developed. In fact, the current state of "ownership failure" is partly due to the difference between tangible and intangible property.[vii] The liquidity of share ownership — the fact, for example, that an average investor today holds a share for less than one year *vis a vis* three years only two decades ago — has further diluted the notions of ownership and responsibility and created obstacles to their exercise[viii] as has the impersonality of most portfolios. It's the rare investor today who can even begin to tell you what he or she actually "owns."

However, no matter the frailty of the link between a computer entry signifying shareholding and more tangible kinds of property or the transitory nature of most shareholding, the rights *and* duty of owners to require managers loyally to pursue profitable goals is the indispensable organizing energy of the capitalist world. The "end of history" requires a rationale for the conjoining of democracy and global capitalism. Ownership is that link and must have this responsibility.

Atomized, Commoditized, and Lobotomized: A Quick History of Ownership

Despite the privileged place that this type of ownership occupies in our economic system, shareholding has long been an imperfect and vast concept existing in many different manifestations: large and small, individual and institutional, long term and speculative, direct and indirect. Add to that the inevitable conflict between economic, voting, and societal rights — do I opt for my own self-interest, "…The exclusive… benefit of plan participants"[ix] the best interests of the corporation or society, or are all three always the same? — and it's easy to see the amorphous outlines of shareholding ownership.

As noted earlier, an ideal owner would be informed, rationally motivated — as it is cost effective for him to take appropriate ownership action — spacious and long-range in her thinking, and capable of effective and appropriate acts. In practice, of course, there is no ideal owner extant in the United States or elsewhere, nor has there been for decades and perhaps forever.

Since the early 1930s, anyone willing to look at the facts square on understood that the shareholders of corporations no longer played a significant role in their governance, but this realization did not generate any specific response, legal or otherwise.[x] Subsequent decades — largely dominated by war, recovery, and the burgeoning sense that business leadership was a valid proxy for the public interest — would only add to the diluting of shareholder influence, but one innovation especially would serve to atomize corporate ownership, spreading it out thinly among millions of new market participants.

Mutual Funds

As America was working its way out of the Great Depression and into WWII, a new sort of ownership arrangement, the mutual fund, was authorized. Not long after the appearance of this professionally managed, collective investment vehicle, some analysts predicted that mutual funds might refigure the relationship between ownership and management. Doing that, though, required volume, weight, and clout; and for the first 30 years after their inception in 1940, mutual funds did not represent a significant percentage of outstanding shares and attracted little attention from regulators.

Then, as the popularity of mutual funds quickly expanded in the 1960s, all employee retirement plans became consolidated under a 1974 federal statute popularly known as ERISA. The institutional funds now had market heft, but there was still no formal recognition of the importance or possibilities inherent in professional, institutional ownership, nor was there much interest from the institutions in pursuing activist ownership goals. In fact, if anything, just the opposite happened. Market capitalization soared as the newly rich funds poured money into favored corporations, while what few external reins management had to contend with were further weakened by the abdication of ownership responsibility by the funds that were doing the enriching.

I once asked Sen. Jack Javits, one of the "Fathers of ERISA," how he and his fellow founders had managed to combine a rationalized retirement system with a fiduciary ownership base for portfolio companies. Never accused of modesty, Jack was prompt to say: "Bob, we never thought of it."

Today, institutional investors such as mutual and ERISA funds are the giants of ownership, with 76 percent of total equity under management. However, despite this impressive growth, J.W. Hurst's forty-year-old description still rings true: "Some prophets said that these investors, moved by their stakes and informed by their expertise, would begin to play in earnest the supervisory roles of the legendary stockholder; [however], professional fund managers did not seem anxious to incur further responsibilities to their fellow shareholder in the companies in which they invested." Hurst added that these investing giants' inclination to sit out most meaningful ownership battles only "underlined the general failure of shareholding to supply the steady surveillance by which stockholders were supposed to legitimate the power wielded in business corporations."[xi]

Fiduciary and Enforcement Failures

While individual owners can perhaps be excused for failing to exercise their ownership rights — the duty exists but daily life beckons — there can be no confusion as to the legal obligation of institutional investors, the scope of whose fiduciary responsibilities is spelled out in existing statutes and regulations. In 1994, Olena Berg, Assistant Labor Secretary in the Clinton administration, provided an especially cogent review of those responsibilities in a ruling on employee benefit plans subject to ERISA:

> *[T]he Department believes that active monitoring and communication with corporate management is consistent with a fiduciary's obligations under ERISA where the responsible fiduciary concludes that there is a reasonable expectation that such activities by the plan alone, or together with other shareholders, are likely to enhance the value of the plan's investment, after taking into account the costs involved.*[xii]

Yet, despite the clarity of the law and the abundant evidence that such activism is value-generating, there has been not *one case* of activism by a trust subject to ERISA.

Comparable laws and regulations describe the fiduciary responsibilities of those responsible for Mutual Funds under the Investment Company Act of 1940, insurance companies, bank trusts, and foundations and universities ("back door ERISA"[xiii]). Again, various factors have allowed the preponderance of institutional fiduciaries to decide not to be "activist." Most of these businesses perform several different financial functions beyond their fiduciary responsibilities. The resultant maze of conflicting interests is top among the issues preventing these institutions from being effective owners. (A maze, it should be noted, is also a good place to hide from responsibilities.)

Likewise, the US agencies responsible for enforcing beneficiaries' rights have conspicuously been co-opted by the financial conglomerates they are supposed to regulate. The Investment Company Institute has notoriously dominated the SEC for decades, and in recent times the US Chamber of Commerce has elicited shameful fiduciary retreat from the Department of Labor. Further eroding enforcement of fiduciary responsibility is the Department of Labor's lack of enforcement will or competency to do so,[xiv] and the various legal impediments to enforcement actions by private litigants.

Additionally, there has been a general trend in the United States for institutions to conform to quantifiable imperatives and accounting such as those generated by mainstream economists and to ignore rarely enforced yet utterly vital requirements such as trust.

The Courts and Financialization

Judicial recognitions of the applicability of ancient trust law to the institutional investor have similarly been abandoned, ignored, or overruled. In the early 1970s, Henry J. Friendly, the highly esteemed 2nd Federal Circuit Court judge, ruled that institutional trusts were personal and could not be transferred. He was overruled in an amendment to the Securities Act in 1975. A decade later, in 1985, Judge Robert Megarry of the United Kingdom ruled in *Cowan v. Scargill* that trustees must administer property exclusively for the benefit of participants. Both rulings place fiduciary responsibility squarely on the shoulders of these massive portfolio managers, and both now stand alone like road signs to a place long since abandoned.

In recent years, American business and government have also been dominated by the forces of financialization, a culture that places irrefutable priority on increasing revenues. In this post Glass-Steagall[xv] world, conflicts of interest became "synergy" permitting cross selling and other GDP enhancing tricks. These conflicts, which clearly inhibited institutional fiduciaries from functioning as stewards of their portfolio companies, went barely noticed. Efforts by former (and now sadly disgraced) New York State Attorney General Eliot Spitzer and an occasional investigative pass by the SEC define the extent of enforcement; no one undertook a comprehensive review. In economic terms, this enforcement failure actually created a burden on the marketplace as it placed fiduciaries wishing to conform to law and be activist at a competitive *dis*advantage.

Meanwhile, money management has become the most lucrative and important industry in the US and the UK. It is no coincidence that these managers are now richer than the executives of the companies in which they invest: Their fortunes are based on ignoring Megarry and overruling Friendly. Legal niceties defining trustee duties as expressed in ERISA — such as the obligation to administer assets "for the exclusive purpose" and "for the sole benefit" of plan participants — were shunted aside and pushed under the rug in the chase to maximize assets under management.

The Missing "Legendary Shareholder"

With their massive analytic resources and huge numbers of shares under management, institutional investors have both the clout and the capabilities to emerge as the "legendary shareholder" that the theorists look to for legitimating private power. But far from picking up the mantle of engaged, informed ownership, mutual funds and their kith and kin have largely ignored their fiduciary responsibilities. Their trustees, usually institutions, are not only risk averse; the scope of their responsibility has been set forth in enabling federal statutes that plainly were not at all focused on the implications on the governance of corporations.

Nor can we look to plan-sponsor corporations for leadership. They, too, have no interest in being activist, and the prevailing climate allows them to ignore clear legal responsibility virtually without risk.

In all, it's a sorry record, deserving of dismay but not quite despair. For in fact, amidst the prevailing gloom, there are ways of hope.

Optimal Owners: BTPS/Hermes, CalPERS, Norway and a Rockefeller Heir

Despite the current disappointing state of corporate governance among most institutional investors, not every member of this group has been so reluctant to shoulder the mantle of responsible ownership. A select few even comprise the leaders of corporate governance. Three profit-maximizing businesses, in particular, have systematically organized so as to function as optimal owners: the British Telephone Pension System, through its subsidiary manager Hermes; the Public Employees' Retirement System of California (CalPERS); and Norway's Government Pension Fund – Global, probably the most fully realized of all the ownership initiatives.

BTPS, Hermes

Hermes Investment Management, the wholly owned subsidiary of recently privatized British Telephone Pension System ("BTPS") — the largest such fund in Europe — created a business based on its capacity, as an active shareholder, to add value to its entire portfolio.

The late Alastair Ross Goobey, Chief Executive and Investment Officer for Hermes Investment Management and a profound thinker on investment matters, identified what we can call a "governance value gap": *The stock market can only value what it knows; it cannot value unappreciated components*. From that, Ross Goobey concluded that the quality of a company's governance could be understood and quantified so that an "activist" investor might cause change and realize financial benefit as the governance gap narrowed.

To help reap that benefit, Ross Goobey engaged a new type of personnel for an investment organization — individuals with high-level experience in company management, especially in the finance area. Peter Butler, a licensed CPA as well as former finance director of Beresford Sugar and other major listed enterprises, especially provided the real world understanding of portfolio companies. The Hermes Focus Funds[xvi] were thus launched, and over time several billion dollars of assets were brought under management, with the management and performance fees constituting a most attractive supplement to Hermes income.

Beyond this, Ross Goobey had concluded that BTPS would always be "long" UK publicly traded equity securities — in fact they hold 1% of the FTSE index — and that its mode of investment would be largely through a passive index. BTPS would, therefore, achieve a "double bounce" from increases in value of focus companies in the activist funds that were also held in the parent company's index. What Ross Goobey achieved was to create an attractive investment vehicle through which participants could encourage activism at the same time as getting a superior return on their investments.

One of the negative features of index investing is that a fund holds companies that it would not choose to own individually and about whose deficiencies it could do nothing. To get around that problem, Ross Goobey conceived the idea of both special purpose activist funds and an enhanced ownership service ("EOS") to expand ownership initiatives beyond the companies held in the funds. EOS has been successfully marketed not only among public funds but also with such private sector leaders as the Royal Dutch Shell Pension Fund.

Much like its founder, Hermes is the principal "philosopher" of corporate governance among institutional investors. Ross Goobey considered the public equity markets as the equivalent of the Commons in traditional law. Such a formulation promotes the core belief that informed and involved owners are an asset of the economy and for the nation — modern keepers of the Commons. While Hermes is sensitive to social considerations, its activist initiatives to date are focused on situations in which long-term market value enhancement can be achieved. Improved corporate governance has been enabled principally because Hermes developed a business model that generated profit.

The Hermes Focus Funds operate very much according to "City Rules" in persistent but gentlemanly activism, but as unique analysis by a highly respected quartet of international economists has shown, Hermes' quiet voice has yielded a quite loud long-term performance.[xvii] "The Hermes Focus Fund (HUKFF) has been very successful in generating returns for its investors, measured by both annual raw returns net of fees of 8.2%, and abnormal returns net of fees of 4.9% a year against the FTSE all-shares index over the period 1998-2004. We estimate that around 90% of such fund returns is due to activist outcomes."

The authors of this report were given complete access to the Hermes files and were able, accordingly, to develop very specific conclusions as to the efficacy of different modes of activism.

> *Based upon target companies' responses to activism by Hermes we classify these interventions as collaborative or confrontational or a mixture of the two. Using different categories of engagement objectives and the degree of hostility, we relate outcomes to measured abnormal returns to shareholders through an event study. We record very different results from those previously reported. We find that shareholder activism is predominantly executed through private interventions as opposed to shareholder proposals at a company's annual meeting, or filings of proxy statements. HUKFF invested in forty-one companies, and engaged with thirty of them. These engagements involved numerous meetings and telephone calls with Chairmen, CEOs and CFOs.*

Hermes' engagement with companies rarely took a public form, unlike the situation in the United States where vocal and demonstrative owner agitation is more freely accepted.

I first understood these cultural considerations during a meeting with former Japanese Prime Minister Kiichi Miyazawa. After outlining my own views of a capitalist system legitimated by involved and informed owners, I was astonished when Miyazawa said, “Mr. Monks, in Japan you are a dangerous man. We place ultimate value on harmony.”

In other countries, including those in Western Europe, the same tendency away from public confrontations is common. European shareholders, who often have more tools at their immediate disposal than their American counterparts, can better afford to be discrete in achieving their aims. In the UK, for example, focus companies full well appreciated that Hermes, through its own holdings as well as those of the parent company’s index fund, likely controlled 2% of their shares, so the prospect of calling a special shareholders’ meeting was always in mind. With the guidance of the former finance directors on their staff, Hermes approached companies with specific notions as to value-adding changes: “In 28 out of 30 engagement cases HUKFF aims at a substantial restructuring of the operations of diversified firms in order to provide more focus, for example by selling non-core divisions and assets, and by limiting diversifying investments and acquisitions. In more than half of the cases, HUKFF explicitly aims at replacing the CEO or the Chairman, with a view to appointing new executives who are more willing to implement the required business restructuring of the target firm. Finally, in more than half of the cases HUKFF seeks an increased cash payout to shareholders, often related to proposed divestment policies.”

Among the authors’ findings: Changes in CEO and Chairman alone produced “excess returns” of approximately 6%.

The Hermes solution highlights several critical elements of shareholder activism:

• First, the effort must be conducted in a style that is compatible not only with the law but, possibly of even greater significance, the culture of the place where it is being conducted. The UK is not fertile soil for the *sturm und drang* of American activism. Having power for shareholders to remove directors, Hermes had no need to make noise.

• Second, the concept of a “governance discount” — shares selling at a price that did not take into account value-affecting elements in their governance structure — was new. In the years since 2004, a fresh breed of activists has entered the field and, possibly, much of the governance discount has been arbitraged out of the market. Hedge funds with vastly greater sums to invest and less patient attitudes changed the investment atmosphere.

• Third, as competition made it more difficult to find attractive investments, the tendency arose to minimize governance considerations previously thought to be a unique indicator. More money would be invested on the basis of a perceived error in "strategy." This converted a high probability game into one that was substantially more problematic.[xviii]

CalPERS

The Public Employees' Retirement System of California — CalPERS, the largest US pension fund — became an activist shareholder the hard way. In 1984 Jesse Unruh, the legendary State Treasurer and Board Member of CalPERS, read in the financial news that Texaco had paid the Bass Brothers a premium of some 30% over the market price to redeem their shares. When Unruh called the CalPERS office to ask whether the fund was also going to tender its shares, he learned of one of the seamy sides of shareholder activism: Green Mail, a practice thankfully largely abandoned in modern times. In Green Mail, energetic investors would acquire shares of stock and make themselves known to managements as being interested in being involved. Wanted no part of this, the managements acquiesced in the disreputable practice of buying out the "nuisance" shareholder at a premium.

Unruh felt there had to be a better way. Among other measures, he founded the Council of Institutional Investors, a group that has served as a forceful advocate for shareholder activism. At Unruh's urging, CalPERS also committed substantial staff resources to improving corporate governance. Over time, and under the enlightened leadership of Board Chairman Bill Crist and CEOs Dale Hansen and Jim Burton, CALPERS developed a multiple approach to profitable activism.

• CALPERS was the principal outside investor in Hermes and sponsor of several comparable activist funds. A 1996 report on CalPERS success stated, "Overall, the evidence indicates that shareholder activism is largely successful in changing governance structure and, when successful, results in a statistically significant increase in shareholder wealth."[xix]

• Through its Corporate Governance Investment Program (CGIP), CalPERS has also sought to broaden the opportunity set of its portfolio by achieving returns not available in traditional public markets. The highly concentrated program follows an active engagement strategy to unlock value through operational, strategic, and governance changes. CGIP has $5.4 billion dollars of capital invested amongst 12 external corporate governance managers

and co-investment partners. The asset allocation of the program contains both domestic and international countries, including the U.S., Europe, UK, and Japan. Since inception in January 1999 through June 30th, 2007, the Corporate Governance Investment program has outperformed its Corporate Governance (CG) Weighted Benchmark by 795 basis points (net of fees).

• CALPERS also developed a Focus List Program in which it identifies poorly governed domestic US companies and engages with their managements. CalPERS focuses on reforming a company's governance practices with an emphasis on accountability, transparency, independence, and discipline in an attempt to improve shareowner wealth. CalPERS also sometimes utilizes the submission of shareowner proposals as a tool to reform poor governance practices. Historically, Focus List Company programs have demonstrated the ability to produce excess returns to CalPERS assets.

The most successful of the CalPERS' investments has been in Relational Investors, founded by the premier US activist investor, Ralph Whitworth. Whitworth has focused on improving the functionality of boards of directors. Unlike Hermes or CalPERS, Relational encourages its principals to serve on boards and *in extremis* to be Chairman. Whitworth has conducted himself even in highly confrontational situations with such grace and ability that he has been able to enlist representation by the most austere of establishment law firms, Sullivan and Cromwell. By accomplishing this, Whitworth has legitimated the category of shareholder activism as being in aid of legitimate value-adding objectives. It can no longer be dismissed as the adventure of rogues and worse. The simple fact is that the governance improvements innovated and imposed by Relational Investors are possible for one reason and one reason only: They are key ingredients in a competitive *profit-making* process.

CalPERS might well be classified as a Sovereign Wealth Fund in modern parlance — that is, it partakes of the nature of a large state-owned fund — and like such funds, it inevitably falls under a certain level of suspicion as to whether its activism extends beyond economic goals to non-financial or social objectives. For some years, for example, it has classified various countries from the perspective of their governance and other characteristics — a form of negative screening many institutions use to dissociate themselves from what they consider unsavory practices. CalPERS has also "salted" literally dozens of special purpose activist funds with impeccably focused value maximization drivers, among them the

Hermes funds. Yet on the one occasion that CalPERS nakedly pursued a political agenda — a shareholder resolution that sought to impose union organization on Safeway Stores — the resulting outrage unseated the fund's chairman. . (On the subject of profit-making determinations, though, the record — legal and moral — is crystal clear.[xx])

Norway's Government Pension Fund - Global

One of the world's largest Sovereign Wealth Funds, Norway's Government Pension Fund – Global ("Pension Fund") suffers none of CalPERS' restraints when it comes to exercising a full range of activist measures, but the Government of Norway has carefully addressed questions of legitimacy where the Pension Fund is concerned.[xxi] Through its legislative branch, the *Storting*, the government retains certain basic rights – for example, the right to exclude investments, whether in whole industries like weapons-making or in individual companies such as Walmart. The Ministry of Finance makes decisions concerning negative screening and company exclusions. "The objective for the exercise of ownership rights is to promote long-term financial returns. The exercise of ownership rights is an integral and ever growing part of our investment management." Meanwhile, the Fund's manager, Norges Bank Investment Management ("NBIM"), is precise in articulating the scope of its practice of shareholder activism:

> *One of the most important characteristics of the investment made by NBIM is the long time horizon. The Government Pension Fund – Global is, in practice, a reserve fund for the future where the underlying capital is not to be consumed and a positive return is to be assured many generations to come. With such a long time horizon, combined with highly diversified investments in the markets, NBIM as an investor is exposed to trends in the markets about which more short-term investors or investors with a more concentrated portfolio would normally be less concerned. This applies both to the way in which the markets are governed and to issues of a social and environmental nature – in other words, issues which are crucial to the markets' future functionality and legitimacy, and which are often brought together under the umbrella of "ethics." Against this background, it is natural for NBIM to exercise its rights as a shareholder*

in ways which take account of these issues, precisely so as to safeguard its long-term earning capacity.[xxii]

As examples of how the Pension Fund's virtually infinite life expands the scope of societal factors importantly affecting its risks and returns, NBIM has focused on two activities in particular: child labor and children's rights, and lobbying respecting the environment, both of which are of obvious financial relevance to a long-term investor. How can any capital investment be "safe" in a business environment exploiting children and children's labor? How can earnings continue when enterprise overwhelms the governmental processes attempting to establish legitimate guidelines for environmental quality?

While NBIM has not developed a business model to make a short-term profit out of its activist initiatives, it makes clear that expenditure is justified only by the reasonable expectation that correlative value is being created for the Pension Fund. "The main objective of Norges Bank's ownership activities is to protect the long-term financial return on the Fund, as premised on a sustainable development perspective."[xxiii]

Neva Rockefeller

To this list of optimal institutional owners must be added one individual: Neva Rockefeller Goodwin, PhD economist, tireless and acute shareholder activist, and great-granddaughter of John D. Rockefeller. At the May 2008 annual meeting of the company her great-grandfather founded, Neva Goodwin spoke eloquently and forcefully about the shortsightedness of ExxonMobil's current management:

> *In today's rapidly changing energy environment, we are urging ExxonMobil to get back to its strong historical roots in order to better position itself for the future of its industry. ExxonMobil needs to reconnect with the forward-looking and entrepreneurial vision of my great-grandfather. Kerosene was the "alternative energy" of its day when he realized that it could replace whale oil. Part of John D. Rockefeller's genius was in recognizing, early on, the need and opportunity for a transition to a better, cheaper and cleaner fuel. And as he noted: "If you want to succeed, you should strike out on new paths, rather than travel the worn paths of accepted success." We*

recognize and appreciate that ExxonMobil's management has been extremely skilled at managing the oil and natural gas business. However, the truth is that ExxonMobil is profiting in the short term from investments and decisions made many years ago, and by focusing on a narrow path that ignores the rapidly shifting energy landscape around the world, including developing nations.[xxiv]

So it is that the modern Rockefeller family has morphed into an extraordinary shareholder worthy of inclusion into our list of optimal owners. However, that is the *whole* list. One national government, one state pension fund, one denationalized benefit plan, and one extraordinary family comprise not a sample of "legendary" shareholder involvement, but the *sum total* of it. To be sure, other institutions have periodically become involved, but the critical players are the same as they were twenty years ago.

Expanding the Circle

Clearly there is a need to greatly expand institutional participation – corporate pension funds, insurance and banks, as well as universities – in order to be representative of the ownership class as a whole. Expanding this circle will have the undoubted advantage of empowering a greater range of owners to express and pursue their concerns. Expanding it also might allow the US government — today's most active consumer of corporate ownership positions — to find a comfortable space in which to exercise its new-found prerogatives and responsibilities. First, however, we must understand what allowed our model owners to be effective and activist where so many others have failed.

Here, too, three reasons stand out:

• These institutions developed business plans that made activism cost effective, both at the level of the trustee and of the beneficial owners. Shareholder activism is and ultimately must be about making money, not policy: money for the activists and often money for those whose money they employ.

• Each of these groups has a long-term horizon and is broadly invested in the market, with Norway's infinite timeline and diverse holdings setting the standard. Not coincidentally, Norway is also where we see the fullest emergence of what is called "holistic accounting," a language of corporate accountability that conforms with societal priorities. When the very

demand for *continued profits* forces Norway to divest from short-term environmental exploitation or when a quest for *secure income* makes child labor an unacceptable risk, we can see the principals of this new accounting at work. In quite a remarkable fashion, holistic accounting's attempt to comprehensively define the impact of corporate activity tends to dissolve the assumed tension between ethical determinations and profit-seeking activities. Further expansion of this language — and the mindset that underlies it — might help make irrelevant current conflicts in institutional investing. For example, the debate that flared up within CalPERS about who has the right to make ethical determinations for plan beneficiaries could have been quickly squelched by a more broadly defined accounting language.

• Finally, none of these groups has conflicting interests in being activist.

The last point, indeed, is critical. In searching for other examples of effective ownership, we find that conflicting interests of one form or another infect virtually the entire institutional investor world.

Punters, Proprietors, & Inhibitors: Where Are the Other Activist Owners?

Under the memorable rubric "Punters or Proprietors," *The Economist (1990)* published a typically insightful analysis of shareholders. The authors quickly labeled as "punters" those who hold the 30% of outstanding equities invested in index of one sort or another. Likewise, another 20% of the outstanding shares are invested pursuant to a variety of computer-driven algorithms, generally in the search for value anomalies among various industries, companies, and currency denomination. In both these cases, choices are made by mechanistic formula and do not reflect a human being's decision to buy or sell. Another 30% of investors know the stock market solely through their friendly broker. Although brokers are of all kinds, they are paid if their customers buy or sell, the more frequently the better. None of these groups has the long term, informed engagement with their holdings necessary to be activist owners.

So, quite quickly, we are left with 20% of the total who might be thought of as real proprietors or even potential activist investors. These are the owners who consider the long-

term disposition of their funds; who follow the conduct of their portfolio companies; and who are prepared, if necessary, to take steps to assure that defects in the governance or strategy or execution by managements are addressed. McKinsey, the premier consulting firm for corporate management, approaches this question of involved owners from a different perspective[xxv] but generates a complementary conclusion: About 20% of investors — "intrinsic investors," McKinsey calls them —base their decisions on a deep understanding of a company's strategy, its current performance, and its potential to create long-term value.

However, even this one investor in five who may be considered a real owner is furthered reduced by the dirty little secret of shareholder activism. Let's briefly re-screen the major categories of institutional investors from the perspective of activity *encouraging conflict of interest* and thus *inhibiting activist ownership*.

• A "golden rule" among company executives at corporate pension funds goes as follows: My pension fund will leave you alone so long as your pension fund leaves me alone. Further, there has never been an activist intervention by a pension fund governed by ERISA. *Never*. For its part, the Department of Labor has an unblemished record over the last twenty five years of *not* bringing suit against a fiduciary having conflict of interest for failure to monitor portfolio companies.[xxvi]

• Most trustees at public pension funds are appointed or elected and are thus both politically vulnerable and politically conflicted. Why would any company locate new jobs in a state that uses its pension resources to oppose management?

• Conflicts abound equally for financial service firms. Why would any company go out of its way to talk with analysts from an investment company or mutual fund that does not support it? Why would a "focus company" hire such a firm to run its 401(k) program?

• Banks and Insurance companies have a myriad of sometimes conflicting connections with companies, the securities of which they hold in trust accounts. Often the financial importance of the trust arrangement is substantially smaller than that of the other business concerns.

• Many of the trustees of our august universities and foundations depend on the favor – collegial, psychological, and financial – of the enterprises whose securities comprise their endowment. Fifty years after graduating college, I wrote at some length to President Summers of Harvard on this subject.[xxvii]

In short, the deck is stacked against the emergence of this essential class of activist owners. The extent of the problem was glaringly evident in a 2002 speech Alan Greenspan delivered at NYU's Stern School of Business. "After considerable soul-searching and many congressional hearings, the current CEO-dominant paradigm, with all its faults, will likely continue to be viewed as the most viable form of corporate governance for today's world. The only credible alternative is for large — primarily institutional — shareholders to exert far more control over corporate affairs *than they appear to be willing to exercise.*"[xxviii] The emphasis is mine, added to demonstrate Greenspan's confusion of a legal obligation with something a trustee can freely choose not to do. That one of the nation's most respected and powerful economists is seemingly content to allow fiduciaries to shirk their inveterate obligations clearly states the current level of neglect. Yet Greenspan does, however inferentially, confirm the right place to begin.

Rage, Self-Righteousness, & Reform: What *Not* to Do

The current corporate governance situation in America is in shambles. Rage has been personalized in the form of Citigroup CEO Robert Rubin, who received $100 million despite the apparent value of his non-executive advice, and ex-Merrill Lynch CEO John Thain, who ultimately did not get a multi-million dollar reward for dis-service, but these corporations are only way-stations. As bailouts move to the automobile and, doubtless, other industries, the anger will spread and the cry to do something, do *anything* is likely to gain increasing political steam. Unfortunately, the voices of reform currently tend to echo loudest on traditional and discredited energies: government intervention, improved boards of directors, and more enlightened managements. All three options have major shortcomings.

Increase Regulation

Government regulation, no matter how well conceived and competently administered it is imagined to be, will ultimately prove ineffective. History has shown that the main effect of increased regulation is not changing corporate behavior but, rather, increasing the billable hours of expensive lawyers. In the legal arena, corporations hold a distinct advantage in time,

resources and talented individuals, virtually guaranteeing the hegemony of the corporate state.[xxix] This is fundamentally a question of power, of corporations and their CEOs having too much of it, and of the state acquiescing in a passive role. [xxx]

Neither is this a situation that is likely to ameliorate as we move further and further into a world of multi-national corporations. To the contrary, national regulation will only become less effective while a lack of empowered owners will have an increasingly unacceptable impact on society.[xxxi]

Today's world is one in which business ventures are encouraged to expand in response to their commercial urgencies, limited only by compliance with the regulations and customs of host countries. We are now functioning on two levels – the one with territorial limits and popularly elected government, the other without boundaries and a global profit seeking dynamic.[xxxii] Tyco and Halliburton are just a few of the higher profile cases of global corporations simply moving offshore (to Bermuda and Dubai, respectively) to avoid US regulation.

This problem itself is, of course, also international in scope. The *Economist* recently reported on WPP, a big advertising firm, that joined the "small but growing band of firms" that have moved their headquarters. "It took an oft-traveled route, remaining listed on the London Stock Exchange but creating a new parent company that is incorporated in Jersey, in the Channel Islands, and is resident for tax purposes in Ireland."[xxxiii] How long will the world be able to tolerate large corporations apparently not accountable to anyone, certainly not to a single country of legal domicile?

Rely on Strong Boards of Directors

In the Anglophone world, there has persisted almost an obsession that properly led and staffed boards of directors will assure the consonance of corporate enterprise with public interest. Rudely apparent, however, are the inherent limitations of these groups. At its core, a board of directors is a group of outsiders meeting maybe a dozen times a year and working with information and an agenda provided by the chief executive, whose performance evaluation is one of their prime responsibilities.

Beyond the fact that these boards almost seem designed to fail at providing oversight, there is not even agreement on the optimum scope of board functioning and responsibility.

As Jay Lorsch and Martin Lipton dramatically put it: "Directors operate in a vacuum as to the purposes boards ought to be pursuing."[xxxiv] Without such a general consensus on what even effective boards would be doing, the range of director concern can be as narrow as compliance with law or as vast as the human imagination.

In *The Bored Board*, Peter Drucker went so far as to raise the question as to whether standards of board functioning are sufficiently unsatisfactory as to require structural change. Writing nearly three decades ago, Drucker made a strongly-worded case about the boards' systemic failures in oversight: "Whenever an institution malfunctions as consistently as boards of directors have in nearly every major fiasco of the last forty or fifty years it is futile to blame men. It is the institution that malfunctions."[xxxv]

Certainly it's true that very few sitting directors match up with what leverage buyout guru Henry Kravis might call a "real director" — one who, in fact, fulfills the role to its statutory expectation. In a 2004 speech in New York City, Kravis contrasted his activist owner/director role with the mass of people who "show up once a month and whose primary source of income is elsewhere." By performing extensive due diligence and analysis on both his companies and the competition, Kravis said, "We know these businesses as well, if not better, than the management teams. Board meetings are interactive discussions, not reports to passive friendly directors."

The result, claimed Kravis, is just what should happen in a healthy corporation: The company remains focused on the bottom line, management scandals are extremely rare, and shareholders' interests are well protected. Unfortunately, nobody has been able to bottle this formula for directorial success, a failing at least partially due to the fact that Kravis, as head of an equity firm, can leverage his own heft as a major investor in most of these companies he helps oversee. For now, Kravis remains a fairly isolated example of the success that a director can have with the backing of a strong, engaged ownership interest: someone, for example, like Kravis himself.

Rely on More Enlightened Managements

If relying on more enlightened boards represents a triumph of hope over experience, hoping for a spate of more enlightened managements amounts to a willful neglect of the obvious. One need look only to the continuing systemic board failure to rein in excessive

executive compensation to see how hopeless this route is. If shareholders, through their boards, cannot hold CEOs accountable for their compensation, they have neither the right nor the expectation to assume that CEOs will exercise effective accountability in any other area.[xxxvi]

Or one could simply look at the compensation itself. When pay for principal executives bears no correlation to value added, history, or any rational economic index, there is nothing left for it to represent other than the absolute power under existing circumstances for executives to control the allocation of corporate assets. In brief, this is not fertile ground from which reform is likely to sprout.

What *To* Do:
Revitalizing Ownership

Rather than adding to the dusty pile of un-enforced and ineffective regulations or clinging to the myth of a truly effective board of directors — or, for that matter, praying for a crisis of conscience among top management — owners themselves must attempt to resurrect meaningful duty and responsibility in this country, and government, as the biggest Johnny-come-lately to the ownership circle (however it chooses to define ownership), must do its part to repair and rejuvenate corporate capitalism within an American context.

The obstacles to effective shareholder involvement are obviously many. This country has traditionally had relatively weak enforcement of laws and a penchant for strong executives, both disadvantages for owners, The US is also the only country in the OECD without clear statutory rights to replace directors. Yet in the face of such challenges, another, often misunderstood American tradition might well offer a useful solution: low-cost, low-risk governance improvement through litigation.

Indeed, in his search for the "legendary shareholder," J.W. Hurst pointed specifically to legal remedy as a bright spot. "That the general body of stockholders proved in practice unable to use its votes to confer substantive, and not merely formal, legitimacy on the controlling power in large corporations did not show that there was no possible role for the stockholder. Though ineffective as a body, stockholders as individuals might operate as a

check-and-balance force within the enterprise *through lawsuits* or through the stock market."[xxxvii]

A second national advantage, this one of character, pertains as well. Just as we Americans sometimes resist change, we are also unique in our willingness to bear the consequences of it — to endure Joseph Schumpeter's celebrated "creative destruction." Those who cause corporate change are not always heroes in America, but in contrast to other countries, shareholder activism and its many possible disruptions are not generally branded in this country as disloyal or, worse, criminal,

With this national give and take in mind, what is needed is not a departure from American tradition, but a bolstering of our homegrown activists. Our current corporate dysfunction, caused in no small part by the Bush administration's turning the country over to the pro-CEO agenda of the Business Round Table, is best remedied by fostering ownership that will stare down and challenge the unchecked prerogatives of management. While mindful of the American electorate's deep suspicions about state interference, the government's best role in the economy is not none at all, but one which strives to restore a healthy balance of power both between the nation's political and economic forces and within corporations themselves. Leveling this playing field will require sustained and diverse efforts, but the battle begins with growing the commitment of those institutional owners who already stand to gain the most from a healthy equity culture.

Universal Owners

Ironically, the best place to launch a healthy shareholder culture is among the descendants of those investment vehicles that over half a century ago began the atomization of ownership. True, mutual funds and their ilk, despite monumental heft in terms of shares under management, are normally meek about throwing their weight behind any sort of governance initiatives. But as they like to warn in the small print of mutual-fund industry ads, past history is no guarantee of future performance.

Whether they have yet to realize it or not, the large mutual funds belong to a global cadre of what I call "Universal Owners," or UO's: institutional investors who have ownership interest in virtually all publicly traded companies and whose commitment is long term. This class is of immediate interest because they have a concern in preserving the

essential wealth-creating characteristics of equity securities — approximately 6% after inflation. What's more, UOs have commercial interests that are comparable to those of global corporations and can function as responsible stewards because of this congruency. As such, these owners' profit-driven interests line up neatly with the sort of corporate environment needed to help avoid the abuses of recent years.

But UO's have more than a vested interest in preserving equity culture; they also have —in CalPERS, BPTS, and Norway's Government Pension Fund-Global — peer models for how to use their heft and breadth to encourage and sometime impose effective corporate governance. And in holistic accounting, they have both a method and a language for measuring the full costs and benefits of corporate functioning on society — a system for encouraging positive environmental, social, and governance (ESG) change, without ever losing focus on the profit-motive.

An example: Think of a mutual fund with diverse holdings in Business A, a paper mill, and Business B, a salmon fishery. It turns out that Business A is dumping pollutants in a river that then flows past Business B. The mutual fund, faced with not an environmental concern but the fact that Business B's costs in cleaning up the mess far outweigh Business A's cost of properly disposing of the waste, will vote in favor of proper disposal of the waste. The environment is spared, but only as a side effect of an institutional investor's profit-seeking activity. This is admittedly a simple example, but it is neither disingenuous nor unsupported by research, and it shows how holistic accounting liberates the discussion from old entrenched positions.

Up until now, of course, many mainstream investors have shunned ESG goals, calling them costly distractions from shareowner value. However, a similar accounting language with appropriate recognition of externalized costs and such untraditional assets as intellectual property is also emerging from discussions now taking place on a professional level. Leading international law firms, including Freshfields Bruckhaus Derringer, have put powerful legal weight behind arguments that their clients – funds around the world – *must* take corporate environmental, social, and governance risks into account when investing.

The Triad Has a Point

The promise of the deeply invested Universal Owner is not limited to promoting a healthy equity culture or supporting the emergence of an accounting that defuses the apparent contradiction between profit-motive and governance ethics. Just as important, these owners also bring into real-world practice the profound logic of Engel's Triad.

Starting from a seemingly simple three rules – voluntary disclosure of information necessary for appropriate lawmaking, restraint in influencing the making and enforcement of law, and spacious compliance with the law – Engel promises to deliver "corporate functioning compatible with the public good." In the midst of a fiercely competitive, bottom-line capitalism, this could be easy to dismiss as a hollow platitude, but intentionally or not, Engel was laying the groundwork for this new class of owners and their creation of a language that reflects the full costs and benefits of corporate functioning. Through the broad, almost magical lens of holistic accounting, the goal of Engel's Triad – corporate functioning compatible with the public good – is realized by activist Universal Ownership.

Swelling the Ranks

As noted earlier, the number of UO's currently worthy of being considered responsible shareholder-owners, much less optimal ones, is slender in the extreme. Far too many of those who might otherwise qualify are indisposed to commit resources to meaningful shareholder activism or unaware (willfully or otherwise) of the profound effect of improved governance on bottom-line performance. The credibility and effectiveness of any reform movements depends on participation by a full-range of ownership, not a narrow slice of it.

However, successful further expansion into the territory opened up by holistic accounting and the tiny (but powerful) vanguard of UO's promises to answer a quandary that has existed in American corporate affairs for generations. Fifty years ago, my very wise law school professor wrote wistfully of "institutional arrangements which — like the party system — could make it possible for many scattered individuals to concert their suffrages on issues sufficiently defined to warrant meaningful conclusions about an expression of their will." Such institutional arrangements, he concluded, "are absent in the relation of the shareholder to his corporation."[xxxviii]

I admit to a certain pride (mingled with considerable exhaustion) in the fact that "institutional arrangements" to this end are now more plentiful than ever. A variety of global services— ISS, RiskMetrics — facilitate proxy voting and other ownership functions at competitive costs. Useful membership organizations such as the International Corporate Governance Network (ICGN) are also helping tilt the scales in the right direction. ICGN has recently compiled a vastly respected "Statement of Principles on Institutional Shareholder Responsibilities" that begins the process of defining parameters for effective global ownership activity.

The momentum toward resurrecting effective ownership, in short, does exist. The question is how to keep it growing. That answer, I think, can be found in a classic motivator: the stick, lightly administered.

The Government's Stick

The first essential in empowering and activating UOs is a proclamation that informed involvement by owners in corporate governance is a public good, and nothing would give that proclamation more gravitas than for it to come from a new president at the helm of a government newly involved, even if only of necessity, in corporate ownership.

Beyond issuing such a statement, though, President Obama should not proscribe exactly what sorts of response he requires from the private sector or from institutional investors. Instead, President Obama should follow up on his call for a "new era of responsibility" by ensuring that his relevant cabinet members shoulder their duty to administer trusts for the full benefit of plan participants. This will take undoubted political courage and conviction, but not any new legislation. As we have already seen, the road to our current state is paved with (largely ignored) regulations. We merely need those responsible for enforcing already existing laws — the Secretary of Labor (ERISA), the Chairman of the SEC (Mutual Funds Act of 1940), the chairman of the Federal Reserve Board, and certain bank trusts – to enforce compliance to the full letter of the law.

Once faced with the reality that there will be effective ownership monitoring of their businesses, many corporations may indeed decide the best way forward is by funding some the costs of active ownership and providing necessary information. Corporations can also

create, in the Scandinavian model, multiple classes of stock with the franchise rights being reserved for those who accept the responsibilities of ownership.

What about the Banks?

Empowering shareholders — given them the tools and the rational for exercising their ownership responsibilities and the spine to see the process through — is necessarily a long-term project. Meanwhile, a more immediate aspect of the financial crisis is staring us in the face: the continued and enormous uncertainty in the financial sector, despite the infusion of hundreds of billions of taxpayer dollars.

As government credit continues to provide live support for America's major financial institutions, the country finds itself on the brink of at least a partial and temporary nationalization of the banking industry, yet our political biases are such that the United States has precious little experience running national industries. So perhaps an idea from abroad can profitably be imported to meet this contingency: the creation of a special purpose government corporation modeled after the United Kingdom Financial Investments (UKFI).

In a situation very similar to that in America today, the British government created UKFI in November of 2008 to vote the government's shares in recently nationalized British banks. Although the UK has a stronger tradition of government ownership of business ventures, the UKFI was created with the distinctly American-sounding hope of avoiding the entanglements and inefficiencies that have bedeviled government-owned corporations at least since the time of Adam Smith. Thus, the UKFI is a British attempt to own up to its shareholding responsibilities while keeping the government at "arm's length" from the company itself. In fact, at the hearings leading up to creation of UKFI, Chancellor of the Exchequer Alistair Darling was at pains to assure the House of Commons that government involvement would be informed by "maximizing sustainable value for the taxpayer."

Could a "USFI," modeled on the British example, provide our own government with a way to meet its bank ownership duties while sidestepping the worst abuses of federal meddling? I think the argument is compelling in its favor, but there's another, broader, and ultimately more sweeping reason for favoring such an approach.

The USFI's Secret Life

Perhaps just as important as providing government with a mechanism for meeting its ownership duties, this special corporation also could be a catalyst for more effectively organizing non-governmental owners – institutional and otherwise – with an eye towards restoring the balance both within the corporation and between business and Washington.

In addition to conflicts of interest and a narrowly imagined but practically transcendent profit motive, one of the real problems in organizing collective action by institutional investors over recent decades has been that nobody has the credibility to convene this large group. Despite studies and real-world examples of how corporate governance can increase profitability, no fund or large group has been prepared to surrender its sovereignty or enable any commitment of resources toward the larger goal of functioning effectively as owners.

However, with the resources of a major owner – the government – dedicated to strengthening ownership culture, other shareholders would benefit dramatically. In addition to the government's catalyzing leadership, access to resources such as independent audits and additional information on compensation, nominating, and other committees normally dominated by management would be invaluable to these owners.

What's more, following the productive ownership roles blazed by our cadre of active Universal Owners, the USFI could also utilize and further legitimatize the language of holistic accounting. By opening up and formally endorsing a space where "maximizing sustainable value" (in Alistair Darling's phrase) doesn't conflict with environmental, social, and governance (ESG) goals, the USFI could be a force for stronger ownership, healthier corporate environment, and the public good.

While it is seemingly counterintuitive to view the creation of a government corporation to vote the shares of recently nationalized industries as a step *toward* the relatively state-free corporate balanced envisioned by Engel and Eisenberg, a well-managed USFI would stand our current crisis of ownership on its head by encouraging good corporate governance without expanding regulation. Properly executed, this is a course that both deflects government meddling and complies with the numerous theories of the corporation that call for vital, empowered ownership as a critical check on the power of management. In fostering activist shareholders – particularly at the institutional level – the government can

encourage a form of accountability that is natural to corporate structures, unlike superimposed, state-devised frameworks. And thus, the mutually supportive coexistence of a wealth-creating capability and a democratic state can continue to prosper.

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i Francis Fukuyama, Summer 1989, *The National Interest* - "The struggle between two opposing systems is no longer a determining tendency of the present-day era. At the modern stage, the ability to build up material wealth at an accelerated rate on the basis of front-ranking science and high-level techniques and technology, and to distribute it fairly, and through joint efforts to restore and protect the resources necessary for mankind's survival acquires decisive importance."

[ii] Fredrick Hayek cautions against the understandable desire to incorporate public policy priorities within the operational dynamics of private companies: "...[O]nce the management of a big enterprise is regarded as not only entitled but even obliged to consider in its decisions whatever is regarded as the public or social interest, or to support good causes and generally to act for the public benefit, it gains indeed an uncontrollable power - a power which could not long be left in the ends of private managers but would inevitably be made the subject of increasing public control." F.A. Hayek, Law, Legislation, Liberty, Vol. 3, The Political Order of A Free People, University of Chicago Press (Chicago, 1979) at p. 82.

[iii] Engel, David, An Approach to Corporate Social Responsibility, 32 Stanford L.R. 1 (1979), but c.f. Lindblom, Charles, Politics and Markets.

[iv] Melvin Aaron Eisenberg, 89 Columbia Law Review 1461, 1523 (1989).

[v] James Willard Hurst, The Legitimacy of the Business Corporation in the Law of the United States, 1789-1970, (U.Va., 1970) at p. 85.

[vi] Scholars have devoted much energy in the effort to "prove" that shareholders do not "deserve" a position of primacy within the corporation constellation. This work focuses in the wrong direction; the problem is the need for real owners following the breech of the atom of ownership into many disparate parcels." According to the idea of property rights, corporations are property and the fundamental aim of their managers is to satisfy the property owners, the shareholders. Doing so will be good for the community. Once, when shareholders were a relatively small number of easily identifiable persons, the idea made sense. The manager could ask them what they wanted - long-run market share or short-run financial returns - and act accordingly. ..... Many managers acknowledge the negative effect of the myth of shareholder ownership, but they continue to hold on to it because it has been the source of their authority. If that idea goes, from where do they derive their authority? In practice, the idea is clear: it comes from those whom they manage and from the community in which they operate. This is the new reality, and it is fearful. If authority comes from the managed, then relationships with employees cannot be adversarial and contractual; they must be participative and consensual. If authority comes from the satisfaction of community needs, then those needs must be efficiently defined in a reliable way by government. George Lodge, Perestroika for America --

Restructuring Business-Government Relations for World Competitiveness, (Harvard Business School, 1990), at pp. 6-7.

[vii] "The capitalist process, by substituting a mere parcel of shares for the walls and the machines in a factory, takes the life out of the idea of property. It loosens the grips that once was so strong – the grip in the sense of the legal right and actual ability to do as one pleases with one's own; the grip also in the sense that the holder of the title loses the will to fight, economically, physically, politically, for "his" factory and his control over it, to die if necessary on its steps. And this evaporation of what we may term the material substance of property - its visible and touchable reality - affects not only the attitude of the holders but also that of the workmen and the public in general. Dematerialized, defunctionalized and absentee ownership does not impress and call forth moral allegiance as the vital form of property did. Eventually, there will be **nobody** left who really cares to stand for it -- nobody within and nobody without the precincts of the big concerns." Joseph Schumpeter, Capitalism, Socialism and Democracy, (Harper & Row, New York, 1942), p. 142.

[viii] "The owner of non-liquid property is, in a sense, married to it. It contributes certain factors to his life, and enters into the fixed perspective of his landscape..... At the same time, the quality of responsibility is always present. It is never possible, save with the irresponsible, the spendthrift, or the disabled, to decline decisions. As one financier put it pithily, 'If the horse lives, the owner must feed it; if he lets it die, he must at least bury it.'... Only as the energy or resources of an owner are spent in feeding a horse, of tilling a farm are they capable of rendering a service to him So long, then, as a property requires contribution by its owner in order to yield service it will tend to be immobile. For property to be easily passed from hand, the individual relation of the owner to it must necessarily play little part..... Thus if property is to become a liquid it must not only be separated from responsibility but it must become impersonal- like Iago's purse: "'twas mine, 'tis his, and have been slave to thousands". Adolph A. Berle & Gardiner C. Means, The Modern Corporation & Private Property (Transaction Publishers, 1991), at p.249,250. The sense of déjà vu, all over again, intrudes with the circumstances of securitization and the sub prime mortgages in 2008.

[ix] Employees' Retirement Income Security Act of 1974 ("ERISA") Section 404(a)(1)(A)(i)

[x] Beyond the provisions of Section 14(a)(8) of the Securities Exchange Act of 1934 providing the machinery for "shareholder democracy", which has been more or less stillborn.

[xi] Hurst, op.cit.supra, at 87,88

[xii] Department of Labor – DOL Opinion 94-1

[xiii] The thirteen year legislative history of ERISA demonstrates the irony that the original focus of the legislation was public pension funds and yet, ultimately, only private pension funds were included within the purview of the statute. Practitioners took the position that the fiduciary requirements of ERISA could be included within the qualifying requirements for tax status under the provisions of the statute relating to the IRS. So, universities, public pension funds and foundations all depend on IRS classification as "tax exempt" for their normal functioning. Arguably, the fiduciary requirement of shareholder activism could be a critical element in this classification.

[xiv] GAO Report to the Ranking Minority Member, Committee on Health, Education, Labor and Pensions, US Senate, GAO-04-749 (August 2004)

[xv] The Glass Steagall Act was passed in the 1930s in order to separate deposit taking institutions and investment banking. Its repeal which legitimated, inter alia, the merger of Travelers Insurance and Citigroup appears to be associated with enabling the problems that the original act was designed to prevent.

[xvi] The commitment of BTPS is long term. The use of a special purpose investment vehicle – Hermes Focus Fund – is a short term oriented way of accomplishing two objectives. First, it generates profit that funds the effort; second, it demonstrates clearly that there is such a thing as "governance discount". The most notorious iteration of shareholder activism is as a component of "risk arbitrage". Risk arbitrage has existed since the beginning of markets based on the ability of the operator to identify what the economists call infelicitously "market place inefficiencies". This typically arises in the case of announced mergers where the market prices of the component companies are fixed with a particular bias as to the probability of the deal being consummated. The "arbs" inform themselves and make "bets". A recent innovation has involved identifying poorly governed companies, acquiring positions where the company seems mispriced compared to its peers, and then – not waiting for change – but functioning as an activist shareholder to be sure that the desired change takes place immediately. Shareholder involvement ranges from tender offers to buy outstanding shares to full scale proxy contests to replace the board to direct and sustained conversations with the management. This shareholder activism provides a way for particularly skilful and aggressive investors – Guy Wyser Pratt is the dean and Carl Icahn is the Emperor of this group – to make money for their own investors. Economists have claimed that the market place will correct failures. Carl Icahn must have a special place in their heart as he perceives governance failures as opportunity and does not hesitate to involve himself. He recently (Blog – July 30, 2008) described his role: "My job is not to micromanage the companies in which I invest, but to choose the right managers who can effectively design and execute a successful strategy and hold these managers accountable if they do not perform. This is what I have attempted to do at the companies I own outright and others in which I invest. As many of you know, especially with the companies I control, these companies have turned out to be extremely successful and financially rewarding for all stockholders. " Alan Patricof, a veteran investor, neatly lifts the veil of board sanctity and welcomes Icahn's service as a director of Yahoo. "He will exercise his fiduciary duty to represent all of the shareholders and use his business judgment as to how to guide the company on strategic issues. He will also be restricted by Sarbanes Oxley on how he behaves and, if we are really lucky, he will be appointed to the audit committee and have the further burden of being a steward of the company's finances. Based on my experience with public company boards, board meetings usually take 3-4 hours but audit committees require an additional 3 hours. Carl can use his creative talents to maximum advantage by channeling his financial acumen towards helping the company on a constructive basis in meeting the challenges faced in being a director of a public company. (I can't wait until he deals with Section 404 of Sarbanes Oxley and has to judge Yahoo's internal controls.) Alternatively he can serve on the compensation committee and deal with employee retention issues and creating imaginative pay-for-performance structures. Better still, he can assume the role of lead director, an important position for an independent director to interface with shareholders and be responsive to grievances from unhappy shareholders. In my opinion the most constructive part of the settlement is the requirement that Icahn Enterprises maintain holdings of at least 30 million shares (currently valued at $650mm) in order to retain the board seat. This is as it should be. If a shareholder wishes to be an activist, he or she should have an interest in the long-term success of the company and not have the luxury of agitating in public with no constructive plan, no burden of fiduciary obligation and the ability to swing in and out at their pleasure. Long-term owners, in my opinion, are permitted to express their opinions vocally and through the proxy mechanism. In his new role, Carl will now have access to the deliberations and issues faced by the existing board in considering whether to accept the Microsoft offer of $33 per share. He may find that it was not a clear black and white decision and that there may have been mitigating factors to be considered which complicated the company's response. We will never know, since those were matters for board consideration, but perhaps Carl will now have an insider's perspective on the decision process." (Alan Patricof Blog, July 24, 2008)

[xvii] Becht,Marco, Franks,Julian, Mayer,Colin, and Rossi, Sefano, Returns to Shareholder Activism Evidence from a Clinical Study of the Hermes U.K. Focus Fund., http://ssrn.com/abstract=934712 (2006) All subsequent quotations in this paragraph come from this source.

[xviii] In early 2009, Hermes announced the unsatisfactory performance of the Focus Funds and the reorganization of that department.

[xix] Michael Smith, Shareholder Activism by Institutional Investors, Evidence from CalPERS, Journal of Finance (March 1996)

[xx] The Department of Labor, almost mischievously, muddled the previously clear instructions to ERISA fiduciaries – 29 CFR 2509.08-1 and 29 CFR 2509.08-2. These apparently politically motivated pronouncements hopefully will be withdrawn in a new political environment.

[xxi] Government Pension Fund – Global publishes virtually all relevant information on its web site http://www.norges-bank.no/templates/article . References in this paper will generally be Consultation paper – Evaluation of the Ethical Guidelines for the Government Pension Fund- Global (July 2008)

[xxii] Ibid.

[xxiii] Ibid at 3.3

[xxiv] PR Newswire, April 30, 2008

[xxv] Palter, Robert N. Rehm, Werner, and Shih, Jonathan, McKinsey Quarterly, April 2008 Executives spend too much time talking with investors who don't matter. Here's how to identify those who do. Communicating with the right investors.

[xxvi] United States Government Accountability Office, PENSION PLANS Additional transparency and other Actions Needed in Connection with Proxy Voting (GAO-04-749 August 2004)

[xxvii] http://www.institutionalshareowner.com/commentary.html?id=14

[xxviii] Greenspan, Alan, Remarks at the Stern School of Business, March 26, 2002

[xxix] The economic costs of state directed enterprise are high. We really do not know enough to draw conclusions about China. Dirigisme has long been employed in France; Germany, Japan and Korea epitomize partnership between government and private enterprise; Scandinavia has a culture involving private parties acting for the state. Each of these situations involves the cultural and political climate of the particular country. In talking of a global economy, multinational corporations, we must take into account that there is no global government or global culture.

[xxx] With Allen Sykes, I have written at length about this - ***Capitalism without owners will fail: A policymaker's guide to reform*** - **Centre for the Study of Financial Innovation.**

[xxxi] "For many years, a wishful presumption has existed that, in time, the hegemony of global corporations would lead the way to the construction of a new international political order – world institutions that have the representative capacity to govern equitably across national borders. That prospect is not at hand in our time. On the contrary, what is emerging for now is a power system that more nearly resembles a kind of global feudalism – a system in which the private economic enterprises function like rival dukes and barons, warring for territories across the world and oblivious to local interest, since none of the local centers are strong enough to govern them. Like feudal lords, the stateless corporations will make alliances with one another or launch raids against one another's stake. They will play weakening national governments off against each other and select obscure meeting places to decide the terms of law governing their competition. National armies, including especially America's, will exist mainly to keep the contest free of interference." William Greider, Who Will Tell the People - The betrayal of American Democracy, (Simon & Schuster, 1992) at p 401.

[xxxii] This is not the place to more than mention the analogous pattern between nation states and global religions. The First Amendment to the US Federal Constitution separated Church and State; in hindsight it may be regrettable that there was no explicit separation of Corporation and State.

[xxxiii] 7-14 December 2008

[xxxiv] Jay Lorsch, Leslie Berlowitz and Andy Zelleke, eds, Restoring Trust in American Business, Cambridge MA: MIT Press, 2005, ISBN 0-262-74027-3, at p. 74

[xxxv] Drucker, Peter, "The Bored Board," in Towards the New Economy and Other Essays, (Harper & Roe, New York 1981), 110

[xxxvi] I always wondered why Sears Roebuck thought it was worth upwards of $20 million to prevent my joining the board of directors. At the time, I was serving as director of several companies larger than Sears and had proffered letters from the CEOs to the effect that I was housebroken. What harm could I effect when I couldn't even get a second to any motions I might advance? In the American context, I have come to the unhappy conclusion that utter discipline in board accession is a part of the disgraceful escalation of CEO pay. "No matter what ultimately emerges as a generally accepted definition of optimum scope for board responsibility there is a continuing fixation that some majority of the directors should be found to be "independent". Analysis of previous board malfunction is virtually overwhelmed by the insistence on yet larger majorities and more extensive definitions of "independent" - "At present the consensus view as to corporate governance best practice is so dominant that it is difficult even to suggest that further empowerment of an independent monitoring board may not be the solution to the current round of corporate scandals and flagrant abuses. Nevertheless, after watching independence and empowerment ratcheted up and up and up for 30 years, our conclusion is that enough is now enough. It is time to recognize that other best practice models of corporate governance need to be evaluated….. The point is that by turning the corporate board into the 'monitor' of corporate management, we do not appear to have been able to stop the scandals and flagrant abuses, and we may well be losing the vision, advice, and competitive perceptiveness that a good board should be providing the CEO. Surely there must be better ways to deal with the consequences of the separation of ownership from control in the modern corporation. The time has come, we believe, to think outside the consensus box." Lorsch, op.cit.supra.

[xxxvii] J.W.Hurst,op.cit.supra, at 98 (emphasis added).

[xxxviii] Abram Chayes, December 1960, introduction, pages xvii + xviii, John P. Davis, Corporations, originally published 1897, republished Capricorn Press 1961.

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SHAREHOLDER ACTIVIST AND CORPORATE GOVERNANCE ADVISOR

MY BIOGRAPHY

Robert A.G. Monks is the publisher of http://ragmonks.blogspot.com and http://www.ragm.com, which are focused on the assembly and dissemination of information and opinion about global issues of corporate governance. Mr. Monks is a substantial shareholder in, and advisor to, Trucost, the environmental research company. He is also the founder of Lens Governance Advisors, a law firm that advises on corporate governance in the settlement of shareholder litigation. His principal occupation is the development of ideas harmonizing corporate energies with the long-term interests of global society.

He was the founder of Institutional Shareholder Services, Inc., and served as its president from 1985-1990. ISS is now the leading corporate governance consulting firm, advising shareholders with assets in excess of $1 trillion on how to vote their proxies. In January 2007, ISS was sold to Riskmetrics. He founded the investment fund known as LENS, which since 1992 has developed the “institutional activist” mode of investment. The fund has achieved returns in excess of the S&P average throughout its life. In 1998, in partnership with British Telephone Pension Scheme to promote the same investment principles in the United Kingdom, he founded Hermes LENS Asset Management Company of which he served as Joint Deputy Chairman. This fund also exceeded its index performance standard. Mr. Monks served as the President of Henley Management College’s Center for Board Effectiveness from 2000 to October 2003. He is also the board chairman of Governance for Owners – G40 - for both the London and U.S. based share-ownership services venture formed by former Hermes directors Peter Butler and Steve Brown which has initially focused on a European fund informed by the principles of value to be added by proper governance.

He is a graduate of Harvard College, Cambridge University and Harvard Law School. He was a partner in a Boston law firm and served as vice president of Gardner Associates, an investment management company. He was president and chief executive officer of C.H.Sprague & Son Company, a coal and oil concern and served as a board member and chairman of the Board of The Boston Safe Deposit & Trust Company and

the Boston Company. He served as director of the United States Synthetic Fuels Corporation through appointment by President Reagan who also appointed him one of the founding Trustees of the Federal Employees' Retirement System. He served in the Department of Labor as Administrator of the Office of Pension and Welfare Benefit Programs having jurisdiction over the entire U.S. pension system.

Mr. Monks has served as a member of the board of directors of ten publicly held companies. He has spoken, written and testified widely on corporate governance matters over the past twenty years. These materials are largely available at www.thecorporatelibrary.com, including the full text of the first of three books he co-authored with Nell Minow, Power and Accountability (Harper Business, 1991). With Nell Minow, he also wrote Corporate Governance (Blackwell Publishing, 1995), the 4th edition is scheduled to be published in January 2008, and Watching the Watchers (Blackwell Publishers, 1996). He wrote The Emperor's Nightingale (Capstone, April 1998) and The New Global Investors: How Shareowners Can Unlock Sustainable Prosperity Worldwide (Capstone, May 2001). Mr. Monks was also the subject of a biography chronicling the corporate governance movement – A Traitor to His Class - by Hilary Rosenberg published by Wiley in 1999. Mr. Monks first novel, Reel and Rout was published by the Brook Street Press, February 2004. In December 2007, Mr. Monks' Corpocracy was published by Wiley.

Mr. Monks was also 2008 Co Chairman of Republicans for Obama in Maine, and is the Co Chairman of the 2008 World Economic Forum Council on Corporate Governance.

Mr. Monks has received a number of awards and accolades in the course of his distinguished career, including:

2008 Directorship 100 Hall of Fame Award - Directorship Magazine
September, 2008 - "Scholars tracing the origins of the American shareholder movement would do well to start with Robert A. G. Monks. The cofounder of Institutional Shareholder Services (now part of the powerful RiskMetrics Group), The Corporate Library, the LENS Fund, and Governance for Owners is the ultimate shareholder activist, inventing new methods to measure, rate, and monetize corporate accountability for the good of investors. Some board members may see him as a polarizing figure—his latest book is titled Corpocracy—but his influence on the role of directors is undeniable."

2007 Outstanding Financial Executive Award - FMA (Financial Management Association)
October 19, 2007 - The Financial Management Association International (FMA) was established in 1970 and has become the global leader in developing and disseminating knowledge about financial decision making. FMA's members include academicians and practitioners across the world. FMA seeks to broadens the common interests between academics and practitioners; provide opportunities for professional interaction between and among academics, practitioners and students; promote the development and understanding of basic and applied research and of sound financial practices; and enhance the quality of education in finance. FMA sponsors numerous awards and honorary recognitions to recognize and encourage outstanding scholarly achievement and practice in the field of financial management. Its Outstanding Financial Executive

Award is awarded at the FMA's annual conference, and is one of its most important and distinguished awards.

Special Award for Corporate Accountability - Investor Relations Magazine
April 1, 2004, NEW YORK - "New York Marriott Marquis played host to an evening celebrating the best of US investor relations: the ninth annual IR Magazine US Awards in association with Barron's. MC for the night Maria Bartiromo, CNBC anchor, welcomed the 800 guests, and noted the importance of celebrating best practice in the difficult economic environment. A new feature for this year's ceremony was the award for corporate accountability, sponsored by Freddie Mac, and awarded to governance experts Bob Monks and Nell Minow. Accepting the award, Minow referred to the fact that The Corporate Library, of which she is the editor, recently awarded Freddie Mac a 'D' rating for its corporate governance. 'If there was an award for good sportsmanship, it should go to Freddie Mac, as we gave them such a horrible rating!' she quipped. Winners for the awards were chosen in 20 categories through an independent survey of 3,514 investors and analysts conducted by New York-based Erdos & Morgan. Interviews with buy-side analysts and portfolio managers, sell-side analysts and retail investors took place from January-February 2004. Thomson Financial supplied contacts from the buy side and sell side while WILink and Barron's Online supplied individual investor contacts. The full results, together with comments from respondents about the nominated and winning companies, are available in the IR Magazine US Awards 2004 research report."

2002 International Corporate Governance Award - ICGN
November 5, 2002 – Bob Monks, an American who is a world leader in corporate governance and shareholder engagement, has today received the International Corporate Governance Award from the ICGN (the International Corporate Governance Network) in recognition of his achievements in the field of corporate governance. The award is presented to individuals who have markedly improved the state of corporate governance in one or more jurisdictions, overcoming challenging obstacles requiring vision, courage, and fortitude.
Presenting the award to Bob Monks, Sir Adrian Cadbury, the recipient of last year's inaugural award commented, "Bob has been in the forefront of corporate governance for over 20 years, during which time he has made a major contribution to the theory and practice of corporate governance both in the US and the UK."
Monks said, "I am delighted to receive this award from the ICGN which continues to be the global thought leader on issues of corporate governance. In the wake of economic downturn and corporate failures, corporate governance is more important than ever to long term growth and sustainability. I believe we are winning the intellectual and economic arguments supporting our cause and that the value of sound corporate governance has become widely recognised. Good governance is the essential component of equity culture; a healthy equity culture is the basis of personal and national wealth. Organisations like the ICGN make a vital contribution to this campaign and I look forward to the new challenges that lie ahead for the corporate governance movement in the future." The award was presented at Hermes' Stewardship & Performance Dinner, which was held in London on Monday, 4 November 2002, in front of around 120 guests from 20 countries.