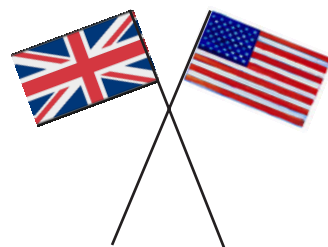


Capitalism without owners will fail:

A policymaker's guide
to reform

Robert Monks and Allen Sykes



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Robert Monks and Allen Sykes

Preface

This is the first paper that the CSFI has published simultaneously on both sides of the Atlantic – something that has become possible as a result of setting up a 501(c)3 not-for-profit corporation in New York earlier this year. I hope that we can look forward to a steady stream of reports and round-tables that bring European issues to an American audience, and *vice-versa*.

The reason that this paper is such a natural to launch the NY CSFI is that the question of corporate governance is so fiercely topical in both the US and UK. You say *tomayto*, and I say *tomahto*. You say Enron, Tyco and WorldCom, and I say Marconi – where the destruction of value has been on at least as great a scale, even if evidence of fraud is lacking. This is the issue of the day, and it is crucially important that the window of opportunity for genuine reform not be slammed shut – as many fear it will be if we do not move fast.

The CSFI is, therefore, very grateful to Bob Monks and Allen Sykes for giving us the opportunity to publish their analysis and their recommendations. It is also extremely appropriate that they launch the NY CSFI since they occupy broadly analogous positions on each side of the Atlantic – well-respected and long-established proponents of better corporate governance whose views are firmly rooted in the real world of business and investment.

I believe that very few readers will dispute their general analysis: there *is* a problem, it is a *systemic* problem, and it requires radical measures to correct it.

Their proposals for reform are, however, more contentious – but demand respect. The proposals are complex, and I don't want to short-change them, but perhaps the most crucial points are:

- that all fiduciaries (those who hold securities on behalf of others, be they pension fund trustees, investment managers or whatever) must be required to act solely in the long-term interest of their beneficiaries;
- that, where relevant, this means institutional shareholders must be made responsible for exercising their votes in an informed and sensible manner;
- that shareholders must nominate at least three non-executive directors for each major quoted company;
- that non-executive directors must have real control over the audit and remuneration committees – which means that auditors and remuneration consultants must be appointed by, and responsible to, the non-execs, and must have no other business with the company; and
- that properly remunerated (and funded) non-execs must have access to independent advice on all significant M&A activity so that they can genuinely represent the interests of shareholders.

The implications of these proposals – for regulators, for governments, for the non-execs and for the way companies are actually run – are profound. Monks and Sykes suggest that the market itself will provide solutions to some of the problems that will spring up – and they may be right. But even with the emergence of what they call “specialist investors” and “relationship investors”, what we are looking at (and what they are calling for) is a revolution in twenty-first century capitalism.

Andrew Hilton
Director, CSFI

Foreword - Sir Brian Pearse

As we reach the fourth quarter of 2002, there is no doubt that there are more concerns about the process of investment than I can remember since I started my banking career in 1950. (I have deliberately not used the word “capitalism” because it has political connotation, and I do not believe that this is a political issue.)

There is a crisis of confidence because the fall in stock values throughout the world has destroyed the savings of tens of millions of people. Parents who have saved to send children to university right through to those who expected to retire over the next few years in reasonable comfort now find themselves in quite difficult circumstances, having to carry out a major rethink. Even if they are not looking after their own investments, the plight of the insurance companies and pension funds has caused them to change their plans for the future. Many will have to retire later than they had originally anticipated.

All is not lost of course. The markets will improve, although it will require a greater degree of clinical management of some of our major companies than we have experienced over the last few years. In this context, I believe that the paper which follows, by Robert Monk and Allen Sykes, sets the scene for a debate that is urgently needed.

We can be thankful that we have, at least, historically low inflation and interest rates; this has certainly been a very significant help to those buying their houses. Even if there is a shortfall on endowment insurance policies, the overall outlay will be very much less than it would have been ten or so years ago.

There is however a serious lack of confidence in stock exchange investments, and people are floundering about wondering how to provide for the future. Many of the factors which have brought this about are mentioned in the paper, but I would like to elaborate on a few from my own experience.

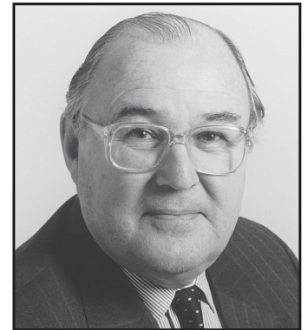
As chairman of an engineering company in the UK, we entered into discussions a few years ago with a company in the US which dovetailed very well with our business. The commercial case for a merger was very strong indeed. However, in addressing the requirements of our shareholders, we had a major problem in reaching agreement on future dividend policy. The UK company pay out rate was far too high, leaving very little surplus for investment. The US company had never paid a dividend, but had satisfied its shareholders with an aggressive share buy-back programme. No one seemed to have noticed that share options issued to staff had left the number of shares in issue virtually unchanged. The practice of both companies was untenable, but none of the shareholders made any comment and did not see the danger.

On a rather different tack, I have always felt that it is not appropriate for a CEO to move into the chairman's position because, once that has happened, the new CEO is at a big disadvantage. (I appreciate that the situation is rather different in the US.) On one occasion, I was isolated as a non-executive director in objecting to this situation arising. Should I have resigned (probably futile anyway)? Or should I have stayed on to try to make the best of the situation? I can only agree with the point made so strongly in the paper that non-executive directors have little real power.

There are several other factors which will undoubtedly figure in any serious debate on this paper.

First, fund managers do indeed tend to be judged on relatively short term results, probably no more than three years. This leaves them with little option but to follow a “tracking” policy. Far too much attention is given to analysts who, in my experience, struggle to understand medium and long term strategy – mainly, of course, because they have never been managers on any scale and have problems in understanding what “the buck stops here” really means.

Second, there are now too few international firms of accountants. Recently, I was involved with a company which did not want to use its auditors for due diligence work in a merger situation. However it had to because all other suitably-qualified firms were conflicted.



Sir Brian Pearse

Third, comment is made in the paper about remuneration committees and the use of remuneration consultants. I agree entirely – and, in addition, at the risk of making the remuneration report slightly longer, I would add one more ratio: the multiplier of the average pay of the bottom ten per cent of the workforce to the *total* (including options) of the CEO. It is this factor, more than any other, which has become unacceptable.

Whether or not Messrs Monks and Sykes have hit on the right answers to the problem which we face will be the subject of much debate over the months to come, but one thing is certain. Confidence will not be restored by tinkering at the edges. We have reached a watershed, and it is now essential to change the governance of companies so that investors can be reasonably certain that there really is adequate independent control over the managers of our businesses. It would help too, if, they could know for certain that there will be no pay-offs for failure.

Sir Brian is a former chief executive of the Midland Bank and finance director of Barclays.

Foreword - Henry Kaufman

Capitalism without owners, the subject of this report, is a problem that has been brewing for some time. It has come to the fore as a result of the recent exposure of many excesses in the US market - exacerbated perhaps by the rapid securitization of financial markets that has tended to widen the gap between the control of corporations (exercised by management) and their owners.

One of the most penetrating critiques of the concentration of corporate control appeared as far back as 1932, when Adolf Berle, a law professor and reformer, and economist Gardiner Means published their landmark book, *The Modern Corporation and Private Property*. As they noted vividly:

It has often been said that the owner of a horse is responsible. If the horse lives, he must feed it. If the horse dies, he must bury it. No such responsibility attaches to a share of stock. The owner is practically powerless through his own efforts to affect the underlying property. The spiritual values that formerly went with ownership have been separated from it.... [T]he responsibility and the substance which have been an integral part of ownership in the past are being transferred to a separate group in whose hands lie control.



Henry Kaufman

My own experience suggests that this challenge to an effective capitalistic system is especially acute in the structure of major financial institutions. This sector deserves particular emphasis because of the critical role financial institutions play in the allocation of credit. In recent years, quite a few major financial institutions have become truly international. They underwrite, they trade currencies, stocks, and bonds, and they manage the portfolios and securities of industrial corporations and emerging nations. Some of the largest contain in their holding company structures not only banks, but also mutual funds, insurers, securities firms, finance companies, and real estate affiliates.

The outside directors on the boards of such firms are at a major disadvantage when trying to assess the institution's performance. They must rely heavily on the veracity and competence of senior managers, who are responsible for coping with a dazzling array of intricate risks involving specialized, lower-level personnel working throughout the firm's wide-flung units. Moreover, those senior managers are themselves dependent on the veracity of their middle managers - who are often incentivized to take on new risks through their compensation arrangements. It is easy for gaps in management control to open up among these groups.

What is often missing for new directors is an intensive orientation program. In particular, new directors must be given a detailed analysis of the individual institution's accounting procedures – covering, especially, the kinds of activities that Enron directors signally failed to appreciate. I would emphasise:

- transactions with affiliated companies;
- the transfer of assets/debts to special-purpose entities in order to achieve "off balance sheet" treatment;
- related-party and insider transactions;

- the aggressive use of restructuring charges and acquisition reserves;
- aggressive derivatives trading and the use of exotic derivatives; and
- aggressive revenue recognition policies.

Directors of a financial institution should also be made familiar with the quantitative risk analysis techniques employed by that institution. Beyond that, I believe a firm's risk analysis group must be independent of the trading and underwriting department. It should be well-compensated, but it must have reporting responsibilities to the chief executive, the chief operating officer, and the board of directors itself.

As part of their orientation process, new directors should be required to meet with representatives of the official supervisory agencies such as the Federal Reserve, the Comptroller of the Currency, and the Securities and Exchange Commission - all of whom should explain what they require from the institution. Legal counsel should also meet with new directors to explain their responsibilities and liabilities.

But this kind of orientation process alone is not enough to achieve effective board oversight. Board meetings should be allotted more time. Directors should be given more detailed information than the highly sanitized and summarized financial information they often get at present. And new skills will be needed. In particular, board expertise in accounting, quantitative risk analysis and information technology will become more and more essential in our complex world of finance.

To be sure, the primary task of boards is to define a firm's strategy, to set policy, and to represent the interests of shareholders and creditors - not to operate the institution. But unless boards devote enough time to their responsibilities, the financial industry will suffer more and more upheavals, forcing government to step in to clean up the mess – and, increasingly, to regulate and control the industry.

Capitalism without owners is not uniquely an American problem. In some other industrial countries, it may even be a greater threat to economic democracy than it is in the US as a result of the concentration of assets in fewer institutions and a more "socialistic" political orientation. The idealistic American view looks to market forces to determine economic outcomes, and accepts the fact that wide economic disparities between winners and losers are a normal consequence of the free market. In contrast, in social democracies around the world, legislatures, elected officials, and bureaucrats play a more important role in the economic decision-making process. In Continental Europe, for instance, the political emphasis is on social justice, fair trade and a kinder and gentler economic outcome than is suggested, at least at first glance, by a more competitive market-driven society.

Equally, in Japan, an economic system run by consensus still holds great appeal. Even after a decade of virtually no economic growth, many Japanese still believe that their society and culture must be based on harmony. In Japan and in Europe, the interplay between big government, big business and big labor combines to limit the freedom of executive decision-making, the mobility of labor, and the incentive for business to excel. It thus raises the question much more strongly than in the US: "Where are the owners and what is their role?"

This report provides excellent insights into a grave shortcoming of modern day capitalism, and offers a number of useful proposals for dealing with it. The shortcoming that the authors identify must be rectified if capitalism is to survive.

Dr Kaufman is chairman of Henry Kaufman & Co in New York.

Introduction

More doubts have been raised in the last twelve months about Anglo-American shareholder capitalism than in any period since the 1929 'Great Crash'. The wave of reckless management decisions, corporate scandals and plummeting share prices has resulted in a crisis of confidence as people's retirement savings have been severely damaged. Behaviour of CEOs, non-executives, auditors, pension fund trustees, investment institutions, regulators and investment banks, which was accepted a year ago, is accepted no longer. The newsworthiness of corporate governance has changed unrecognisably. From being a dry subject, widely regarded as a drag on entrepreneurial dynamism, it is now recognised as central to investor confidence, and hence long-term prosperity. Without good governance, stock markets will remain fragile and volatile.

The marked turnaround in opinion and the apparent willingness of politicians, regulators, and business and financial leaders, not only to accept reforms, but to propose them, may seem to make another report pointless - particularly one addressed specifically to policy-makers. The problem is that the reforms now being urged are mainly not the result of fundamental analysis; the weaknesses that have caused the current corporate malaise are not well appreciated or understood. Until they are, reforms will fall well short of what is needed. Some indeed could compound existing problems or introduce new ones.

We therefore make no apology for writing this analysis of the current weakness in Anglo-American shareholder capitalism. The problems to be addressed are more complicated and often of a fundamentally different nature from what is commonly perceived. Unlike many recent converts to governance reform, we believe in - and hope to demonstrate the existence of - a significant '*systemic fault*'.

Most participants in the debate instinctively reject this notion. ('There are only a few rotten apples in the barrel.') They wrongly perceive it to imply a life-threatening condition, as if shareholder capitalism is somehow fatally flawed. It is not. It is, however, in need of considered reform based on a full understanding of its weaknesses and their underlying causes. In economics, the words 'systemic fault' describe a *type* of fault, not its degree of seriousness. It implies only that the fault cannot be remedied by the individual actions of the various parties concerned, even if all would benefit thereby. Systemic faults require either compulsion or an external catalyst, frequently a change in law or regulation, if they are to be remedied. There may be a large potential gain for the group as a whole from collective action to rectify the fault, but there is insufficient incentive for individual action, particularly when many of the entities are in competition.

In the case of corporate governance, the position could hardly be less favourable to collective action. There is not just one large group that needs to act but several, each with little contact with the others - and, in the case of the many millions of individual and underlying beneficial shareholders, none at all. This explains why - despite many worthy attempts - corporate governance reform over the last decade has achieved so little. Individual incentives and conflicts of interest have proved impossible to overcome by what were essentially appeals for more enlightened behaviour without effective sanctions.

A key example of the systemic fault is what is now widely recognised to be the excessive powers which have been relinquished by the owners to CEOs in both Britain and America, powers which a minority have abused. This gradual, unconscious and unintended transfer explains why the interests of a relatively small number of CEOs have prevailed against those of millions of shareholders. It also explains why the *latent* powers of hundreds of investment institutions have not been mobilised to provide countervailing power. As we shall show, individual incentives and conflicts of interest are simply too great. Effective reform requires that these realities - present in both the US and UK - are addressed, as well as other reforms in auditing and executive remuneration. The exercise of effective ownership has to be made possible and worthwhile, or all other reforms will be undermined. This will involve modest catalytic government action to enable market forces to deliver superior governance.

It should always be a matter of last resort to urge government involvement. But, in the US and UK, it is accepted that some remedial action is required (particularly as current problems are in part the unintended consequence of government tax incentives for institutionalised saving). It is with this constraint in mind that we put forward our own modest proposals.

They are based on our analysis of the numerous weaknesses and conflicts of interest which comprise the systemic fault in Anglo-American capitalism. As observers from Adam Smith to Hayek and Friedman have observed, no-one looks after assets as well as the owners. Hence, our guiding principle has been to make effective ownership possible, i.e. to re-unite ownership and control. Putting owners in charge of what they own is, of course, the purest form of capitalism.

This overview is designed to be read by politicians, business and financial leaders, regulators, and concerned members of the public. Its brevity is possible because it is based on a longer website paper.¹ That paper, in turn, is based on the authors' three recent books,² plus subsequent research. It is not part of the all too familiar "declinist" literature of recent years. Shareholder capitalism is not on the point of collapse despite the worrying events of the last 12 months. It has just developed some persistent bad habits. Properly understood, they admit of remedy. The longer-term interests of the many separate entities involved are damaged by the present dysfunctional system which all are powerless to overcome. The key lies in *integrated* reforms, including modest catalytic government actions to permit market forces to reinforce the effective ownership of public companies. These reforms would restore the full integrity of Anglo-American shareholder capitalism, and hence full investor confidence - prizes well worth the cost of achieving them.

Bob Monks and Allen Sykes

¹ www.ragm.com

² The books are *The Emperor's Nightingale*, Monks 1998 (Reference A), *Capitalism for Tomorrow*, Sykes 2000 (Reference B), and *The New Global Investor*, Monks 2001, all published by Capstone.

No one emerges with credit from the bursting of the bubble

1. The worst crisis since 1929

Threat to equity culture

The Anglo-American equity boom of the 1980s and 1990s was the longest and highest for a century. Real equity returns averaged well over 15%, compared with long-run averages of 7%. However, share prices have fallen (particularly this year) by 40% from their early 2000 peak, and remain fragile and volatile. These developments threaten the long-accepted equity culture as the dominant investment of choice for retirement funds and other long-term savings.

Damaged investor trust

The traditionally higher returns on equities have been based on a trust that has been threatened by corporate governance failures which extend well beyond the relatively small number of spectacular corporate collapses. The evidence shows widespread neglect of responsibilities by all the main corporate players, as well as disproportionate rewards at shareholder expense.

Three governance failures stand out:

- Lack of transparency: The fear, particularly in America, is that financial data is unreliable and biased. Many senior managers and their outside auditors have behaved improperly, and non-executive director audit committees have frequently proved ineffective.
- Lack of accountability: Despite conventional governance codes, the reality is dominant 'imperial' CEOs whose interests have widely diverged from shareholders. Huge remuneration packages have been widely granted bearing little relationship to sustainable corporate performance. (Listed corporate equity holdings by American CEOs have risen in ten years from 2% to 12 % of the total outstanding equity stock.)
- Institutional failure: The investment institutions have failed to protect the long-term interests of millions of beneficiaries, despite their huge latent power (50% plus of shares in America and 80% in Britain). Conflicts of interest arise from their dependence on CEO patronage, which has largely neutralised them.

The gathering storm

The crisis so apparent in the last 12 months has been emerging for the last decade. In neither the US nor the UK has public opinion been fully supportive of business. Doubts have been rather stronger in Britain; but the debacle of Enron and other companies has raised equal if not stronger American worries about where shareholder capitalism is leading and whether modern company law is adequate. The values of big business are now under serious challenge.

Increasing unease

In the United States, for nearly eighty years, lawyers and jurists have expressed concern about the widening separation between shareholders and management - and the resulting abuse of corporate power. The prescient concerns of these pioneers were well summarised more than 30 years ago by Willard Hurst:

“Stockholder surveillance is the principal internal factor on which tradition relied to legitimate corporate power... The continued willingness of our citizens to have privately chosen corporate leaders make decisions affecting production, employment and quality of life has been countenanced because of the accountability of these leaders to the corporate owners... the practical erosion of stockholders’ voting power undermines the very structure of private enterprise upon which our national economy and political system are based.”³

In Britain, similar concerns have produced six official inquiries in 12 years. In both countries, however, there has been an involuntary, indeed largely unconscious, relinquishment of powers to corporate managements. This has left an ownership vacuum at the heart of shareholder capitalism. Hence the resultant abuse of managerial powers - and inevitably a backlash against business.

Investment institutions, lacking the ability to control corporate managements, fall back on the strategy of holding a wide spread of shares combined with a high share turnover. Shares are regarded like betting slips on unforecastable races. Thus shareholders have long been ‘punters rather than proprietors’.⁴

Crisis reactions

Spectacular corporate failures, accompanied by steep falls in share prices, have caused a sudden interest in corporate governance. With many CEOs gaining great wealth while shareholders have suffered badly, politicians dare not remain uninvolved. There has, therefore, been a spate of hearings in America, and much legislation has been drafted to overcome auditors’ conflicts of interest and inadequate accounting regulations. In Britain - with major accounting reforms ten years ago, numerous governance inquiries, and the widespread split of the chairmen and CEO roles - a fairly well established process has been accelerated. Major governance and accounting reforms are thus happening in both countries.

The way companies are governed will now change markedly. But will the changes suffice to reassure shaken public confidence?

Unfortunately, there is no guarantee that rushed diagnoses and hurried proposals will really work. It needs to be remembered that every damaging short-term policy change, every excessive executive remuneration package, and every accounting scam was either approved or condoned by allegedly independent non-executives. Very few institutional investors have ever challenged these practices effectively, or in time.

The case for *real* governance reform, however, is now being made. The most recent study from McKinsey’s shows strong support from a majority of American non-executive directors and from 200 leading investors from 31 major investing countries for a radical rebuilding of the integrity of shareholder capitalism.⁵ To put this support to good effect, the need is to consider

³ “The Legitimacy of the Business Corporation in the Law of the United States, 1780-1970”, J. Willard Hurst *University of Virginia Press*, 1970, p.89.

⁴ ‘A survey of capitalism – punters or proprietors’, *The Economist*, 5 May 1990.

⁵ (i) ‘The need for informed change in the boardroom’ by Bob Feltons and Mark Watson, 2002, and (ii) ‘Global Investor Opinion survey: Key Findings’ by Paul Coombes and Mark Watson, July 2002 – see www.mckinsey.com/governance.

Shareholders are disenfranchised by management

first the serious weaknesses of the present governance of Anglo-American shareholder capitalism.

2. The serious weakness

Market capitalism cannot allocate resources efficiently if shareholders – individual, institutional and beneficial – accept *de facto* disenfranchisement, leaving important decisions almost wholly to senior corporate managements with conflicting interests.

The major inappropriate powers of corporate management

Effective capitalism requires that corporate managements have wide executive powers *and incentives* to develop and execute strategies in the long-term interests of shareholders. To meet this requirement, the wider interests of customers, suppliers, employees and the community must be met, since shareholder profits are the residual after meeting these prior claims.

At the heart of our concern for Anglo-American shareholder capitalism is that chairmen/CEOs and their executive colleagues have at least six inappropriate powers giving rise to serious conflicts of interest:

- they choose their “independent” non-executive colleagues;
- they choose the “independent” auditors, who are also usually consultants with consultancy averaging several multiples of audit fees;
- they choose the remuneration consultants for the non-executive “independent” remuneration committee;
- they exercise influence over the company’s pension fund trustees and their fund managers to take a non-activist corporate governance stance on other companies, implicitly in return for similar reciprocal passivity;
- they have major powers of patronage over other fund managers seeking their pension fund business, who are frequently part of wider financial organisations wanting investment banking or insurance business; and
- they seldom encourage outside advice to non-executive directors on the merits of significant takeovers and mergers, despite the frequent clash with shareholder interests.

The effective removal of these inappropriate powers is the litmus test for any worthwhile reform of shareholder capitalism.

Some of these inappropriate powers are beginning to be addressed. In America, the abuses of Enron, WorldCom etc. are beginning to produce significant regulatory legislation - such as that on accounting regulation and reform, and requiring CEOs to guarantee their financial statements. In Britain, reform began earlier. However, proposed reforms in both countries still primarily address auditor integrity and independence. The other inappropriate powers are not yet widely appreciated.

Deeply entrenched short-termism

If corporate managements have inappropriate powers, they also suffer from a major weakness (which they share with fund managers) that handicaps their performance and damages the

interests of shareholders. This is the market pressure to raise corporate performance, as measured by share prices, over unrealistically short periods of time, often over only 2-3 years.

This is manifested by the shortening average tenure of CEOs, now down to four years (and falling) in both America and Britain. The pressure - mainly from fund managers urged on by investment analysts - is itself the result of the increasingly short periods (typically three years in Britain and rather less in America) over which fund managers themselves are judged. Perversely, this is largely due to the terms imposed by pension funds that are controlled by corporate managements.

Such short-termism is unsuitable for most industries. It prevents managements and fund managers alike from playing to their long-term strengths - to the clear detriment of individual and beneficial shareholders who are saving mainly for retirement. In this matter, corporate managements have a fully justified and serious complaint. However, CEO short-termism is powerfully reinforced by generous contractual termination payments and by the fact that share options usually vest if a merger or takeover occurs.

Absentee ownership, the double deficit

**... and
management
is not
accountable**

The essence of any successful system of governance is that those to whom power is entrusted must be accountable to those whom they serve. Both American and British shareholder capitalism fail this test. Managements are not effectively accountable either to individual shareholders or to the institutions and fund managers who are the agents of the ultimate shareholders. Nor, in turn, are these intermediaries themselves effectively accountable to the ultimate stakeholders - the individuals who are pension fund members or policyholders. There is thus a double accountability deficit which inevitably results from passive, absentee ownership. This is the fundamental weakness of shareholder capitalism. It must be effectively remedied for all other weaknesses to be resolved.

It is a fundamental tenet of free market capitalism that owners choose how their assets are used to best advantage. It is thus particularly unsatisfactory that the largest single category of personal property - stocks and shares (including the beneficial interest held collectively via investment institutions, mainly to provide retirement income) - should lack effective ownership. Those who hold shares directly (50% of all shares in America, 20% in Britain) are individually so insignificant as to be virtually powerless. Those who own shares beneficially are if anything even more powerless. Only if shareholders can *combine* effectively - and in practice this applies only to institutional shareholders - will corporate managements be held accountable. It seldom happens save in a rare corporate crisis - by which time the damage has usually been done (as for instance with Marconi and Enron).

The investment institutions

The only interested parties who could realistically hold corporate managements accountable - the investment institutions and their fund managers - are organised somewhat differently in the US and UK.

In America, the tradition of individual investment remains strong, with half of all shares owned personally. Most of the rest are owned by life assurance companies, mutual funds and defined benefit pension funds, through which companies invest to provide staff with pensions. Under

Can the institutions play a role?

tax incentives introduced in 1970 (the '401' (k) clause), US employers are switching to defined contribution schemes. Often, their contribution to these funds is paid in the form of their own shares, such that many employees (as at Enron) held over 50% of their retirement funds in their own company's stock. (In many mega companies, such as GE and Coca-Cola, the proportion is 75%, and in Proctor&Gamble, over 90%.) While a company is still growing, this may be acceptable; but for employees' jobs and pensions alike to be tied to a rising share price is dangerously risky.

Increasingly, employee contributions to 401(k) schemes go into a wide spread of shares. Mutual funds compete heavily for this huge business. Their corporate governance activities will thus have a crucial effect. However, there is, to date, no real tradition of corporate pension fund or mutual fund governance activity comparable to even the occasional activity of some British investment institutions. The sole exceptions are some of the larger public sector pension funds which are in no way beholden to corporate managements. Thus, in America, opposition to very high executive remuneration – or to the routine repricing of share options - is almost unknown, as is direct pressure on failing CEOs to resign. (American CEOs frequently lose their jobs because they fail to meet short-term performance targets which institutions and fund managers require, but this is due to market pressures not shareholder activism.)

In Britain, individual share ownership has always been much lower than in America. As a percentage of all shares, it has fallen in 50 years from 50% to under 20%. Tax incentives for pension provision (half via individual policies held with life insurers) plus the benefits of professional fund management, have greatly favoured collective shareholding. Hence, British shares are held approximately 25% each by pension funds and life insurance companies, 10% by unit and investment trusts, and 20% from overseas. Increasingly, corporate pension provision is being switched to much less generously funded DC schemes, with most major companies closing their long-established DB schemes even to existing employees.

British investment institutions have occasionally been activist over the last decade or two, but they fall far short of being regularly activist - as last year's important reports by Paul Myners and the Company Law Review group attest. (The leadership of the British Telecommunications Pension Fund and its manager Hermes provide a model for the industry, though it is not one that many have followed.) In part, this stems from their small size relative to that of the companies they invest in. British pension funds seldom hold more than 2-3% of any large company they invest in (life insurance companies hold 3-4%) - and they only hold 2% or less in mega companies. In America, the disparity is even greater. Individual holdings in the top 500 companies seldom exceed 1%, and they average ½% or less. The potential for *individual* investment institutions to influence policy is, thus, small in both countries, and particularly in America. It is only the latent collective power of investment institutions which could give them real influence.

Corporate pension funds, controlled by corporate managements, have almost never been activist in either country. There is an implicit understanding that each company's pension fund will refrain from an activist stance in return for a reciprocal stance from all the others. As for life assurance companies, banks, mutual funds (unit trusts) and investment trusts, they tend to be in fierce competition, and hence co operative action is rare. In addition, many are parts of bigger groups who are also seeking banking or insurance business. There is an explicit duty on all these institutions to be pro active investors on behalf of their beneficial shareholders – indeed, it is trust law in both countries (albeit seldom enforced). But that collective action which alone could be influential is rare; it is largely confined to gross underperformance over many years, or to very serious corporate management misconduct - by which time it is too late.

The fund managers

The same constraints which make investment institutions largely passive owners apply equally to fund managers. These specialists manage the funds of the investment intermediaries, particularly pension funds (few of which are managed internally). Over 75% of fund managers are owned, broadly equally, by investment banks and insurance companies. Most insurance companies usually invest not only their own very large funds (principally of policyholders) but also corporate and public sector pension funds - making them both direct institutional investors and fund managers.

Investment terms are always agreed with clients, but fund managers have the prime responsibility for choosing the strategy best suited to client needs. They unquestionably exercise great power in determining investment decisions. Their top managers and specialists are amongst the highest paid people in the US and Britain, at least equal to most senior corporate managers. In Britain, management of the pension funds of the top 100 companies (over 75% of the UK stock market) is highly concentrated on the top ten fund managers. They thus compete fiercely to attract and retain major corporate business, inevitably reducing their willingness to hold corporate managements accountable.

The reluctance of fund managers to hold corporate managements (their main direct or indirect paymasters) accountable causes them to seek risk diversification by holding widely spread share portfolios - the reaction of a 'punter' rather than a 'proprietor'. This is compounded by the fact that clients expect funds to perform well over relatively short periods - three years in Britain and rather less in America where competition is even fiercer. This highlights one of the most significant weaknesses of shareholder capitalism: the serious mismatch between the periods over which fund managers are judged and the longer periods (say 5-6 years) which would better suit most beneficiaries. Client pressure thus forces fund managers to favour shares expected to perform well over the short-term; this has caused many commentators to blame fund managers for the share bubble and burst over the last 2½ years.

There is a destructive process at work here whereby long-term corporate performance is damaged - and with it the interests of most investors. There are very few incentives for either fund managers or corporate managers to take as long-term a view as their skills justify - yet fund managements blame corporate managements *collectively* for putting them under short-term pressures (and *vice versa*). To break this vicious circle is one of the most important challenges for corporate governance reform.

Fund managers are divided into 'active' and 'passive'. Active funds go in for ever changing selective portfolios and asset allocations, whereas passive ('tracker') funds - now managing 30% of all funds - hold all shares in an index and charge much less. Since passive pension funds tend to perform well in bull markets, active funds have largely replicated their shareholdings (i.e. 'closet' indexing) because there is safety in overlapping portfolios. With most fund managers holding most shares most of the time, they lack an incentive to improve companies in their portfolio since to do so would be almost entirely for their competitors' benefit.

A major failure to hold managers accountable

The systemic fault

Analysis of the investment institutions and their fund managers reveals that, despite their huge latent collective ability to enforce corporate management accountability for their beneficiaries, they do not achieve it.

The institutions are not necessarily to be blamed for this because there is a *systemic* fault which prevents them. The fault is that shareholders - whether individual, institutional, or beneficial - lack the necessary incentives. The fact that all would benefit from introduction of full accountability and superior governance does not ensure that it will come to pass. Unless the members of a group are few, or unless there is some kind of coercion, they will not and cannot act to achieve their common or group interest. There needs to be a sufficient *individual* incentive for enough of the players to make the effort and to bear the costs - even though, if successful, non contributors will benefit at no cost (the “free rider” problem).⁶ Crucially this type of problem cannot be resolved by market forces.

In the case of corporate governance, the position could hardly be less favourable to collective action. There is not just one large group that needs to act but several (individual shareholders, investment institutions, fund managers, and beneficial shareholders), each having little contact with most of the others - and in the case of the beneficial shareholders, none at all. It is this that explains why, despite many attempts at reform in the 1990s, little real change was effected in either America or Britain and why so much more remains to be done. A handful of senior corporate managers in each country can prevail over the huge body of individual and beneficial shareholders. Effective action requires realistic, powerful incentives for effective countervailing power. We argue that the catalyst must be modest but well targeted government action to overcome the systemic fault and create a demand for market forces to provide effective corporate ownership.

The market forces in Anglo-American capitalism which are intended to hold corporate managements accountable to owners have broken down. This has occurred because of the failure of successive governments to enforce the basic law of trust as it relates to conflicts of interest. It is nonetheless essential that a way is found to enable trustees for the underlying beneficial owners, the investment institutions and their fund managers, to discharge their responsibilities. Successful corporate governance reform may require more than this, but it does not require less.

In both the US and the UK, public sector pension funds are the most active fiduciaries because they have few conflicts of interest. However, their staffs generally lack business experience. The more knowledgeable corporate fiduciaries, who could bring business expertise to bear, are – as noted – mainly passive. Hence, institutional activism to date is easily derided as naïve.

We understand the reservations expressed about more regulation, especially given the excessive existing burden in both countries. But if the analysis of a systemic fault is accepted, then change cannot occur without the involvement of an external catalyst. Senior managers are not going to propose reforms which reduce their own powers. Investment institutions and fund managers want to hold on to their major clients, to attract new ones, and to avoid the reputation of a troublemaker. Plus, a conscientious institution would gain only a few per cent of any reward

⁶ Mancur Olsen, *The Logic of Collective Action*, Harvard University Press, 1965 and 1971.

from holding a corporate management successfully to account – but it would bear 100% of the costs, and it may well lose business to more pliable competitors.

Hence, at present *passivity pays*. Passive institutions gain 95% or more of the benefit from any successful shareholder action at *no cost* – and with a real chance of winning business away from the more activist group. It is a no-win situation for conscientious institutions, and a no-lose situation for passive ones. This is the uncomfortable reality facing all who seek to improve corporate governance. (It explains why British institutions are fiercely resisting the essentially modest requirements for institutional activism in the 2001 Myners Report.) Proposed reforms must be judged against this reality, which has been neglected by virtually all corporate governance investigations.

Board composition and accountability - the reality

The traditional view of publicly quoted companies is that they are run primarily in shareholders' interests by senior managers, with closely aligned interests, under the control of independent non executive directors. The truth is otherwise. Shareholders take no part in the nomination of directors. American shareholders have no powers of nomination; nor effectively do British individual shareholders. Moreover, British investment institutions resolutely refuse any such role, despite the strong recommendation of the Cadbury Report. Therefore, chairmen/CEOs nominate them since nobody else can or will become involved.

Nomination committees, consisting primarily of non-executive directors, increasingly recommend non-executive candidates. But the critical appointment (and any renewal) depends on chairman/CEO agreement and is usually at their initiative. Non-executive directorships are generally prized, so how can one hold one's benefactors to account?

While current practice falls far short of the original intention, supporters claim that it avoids the disharmony of non-collegial boards. However, non-executives cannot fulfil their responsibilities if disagreement with CEOs (or even a board majority) is considered disloyal. (Even Jack Welch made clear his "ambivalence" about genuinely independent directors in a famous television interview on September 13, 2002.) What credence can be placed on an 'independent' director who is under pressure not to act independently when required?

Shareholder responsibility for board nominations is very clear in Britain. It is the shareholders' obligation to ensure the services of an appropriate board of directors on a continuing basis, an obligation which is routinely delegated to chairmen/CEOs. But shareholders retain a powerful reserve power. The UK Company Act permits the removal of directors by shareholders at a specially convened Extraordinary General Meeting (EGM). In America, while the obligation is the same, implementation is more difficult. However, reforms now being discussed may permit the same simple activism mandate as in Britain.

The end result in both countries is much the same: there is only ever one set of nominations for directors, who are nearly always unanimously elected. Institutional investors usually give their consent in advance in the form of proxy votes – a process fairly described by Professor M.A. Eisenberg as "coerced ratification". The reality is thus of self perpetuating boards without any ownership involvement. Hence, the oft-repeated dictum that shareholders "...appoint the directors" does not bear serious scrutiny.

**Non-execs
don't
cut it...**

The Enron case is a classic failure by non-execs

The misconceptions

Careful analysis of what boards do (or can do) in a crisis is needed. British boards - with a non-executive chairman and up to half of the board comprising senior executives - are better informed than American boards, where typically the CEO is the only executive member. Nonetheless, non-executives typically devote only 10-15 days a year to board duties (sometimes a little more in Britain), which may not match their growing responsibilities. Boards seem to work adequately only when the demands are predictable and slender.

A window on the Enron board

Senator Carl Levin, as chairman of the subcommittee on investigations, recently provided an authentic view into the nature of US boards at a hearing with the five most senior directors of recently bankrupt Enron. These individuals are the flower of America's director culture. They each had served for seventeen years; they chaired the most important committees – executive, finance, compensation and audit; three had earned doctorates; all were paid a minimum of US\$350,000 a year. They appeared voluntarily and at substantial personal inconvenience and legal hazard in order to articulate plainly and repeatedly that, individually and collectively as members of a board, they were not responsible in any way for the collapse of Enron or for the loss of investments, pensions and jobs.

Despite this, Senator Levin issued a formal report in which he insisted that blame lay at the door of the board. Peter Drucker provides the context: “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.” (The same comment applies to investment institutions and fund managers; it is all part of the systemic fault.) Does the experience of Enron confirm Drucker's conclusion – that you can count on the board except when it is really needed? If so, there are major policy implications.

Some characteristics of Enron's non-executives suggest caution. The unusually high pay, an average of 17 years service and no board self-evaluation all suggest too little rigorous scrutiny of management. Without an independent chairman, an issue never raised, who was responsible for ensuring that the board covered its full responsibilities? In evidence, the non-executives felt they were widely misled – but insisted that they had no direct personal responsibility. For instance, when management set up the ‘independent’ off-balance sheet entities to which corporate assets and debts were ‘sold’, the non-executives would not accept that this was a breach of Enron's conflict of interest rules since they had been given the CEO's assurance that no harm would result.

The details revealed by the Enron hearings are essential to understand the often fragile defences to corporate excess and misbehaviour in American boards. Perhaps non-executives are not able to discharge their responsibilities; if so, the investing public has been mightily misled.

As we turn to the very different situation in the United Kingdom, one question obtrudes – what were the lessons from the Marconi affair? The losses there, albeit absent fraud, were just as egregious as with Enron. And what do we learn from the fact that there were no Parliamentary or regulatory hearings on Marconi – or on the governance of Railtrack? Is this explained by the absence of any fraud? Or is it just a reflection of a more conformist culture?

In both the US and UK, we are seriously misled by the language describing corporate governance. Why do we say shareholders elect the directors and auditors when they take no part? Why do we ignore blatant conflicts of interest? Why do we pettifog endlessly, trying to refine definitions of ‘independence’ which everyone knows to be untrue?

Alan Greenspan’s remark in his March 2002 speech at New York University’s Stern School, that American corporations are essentially characterized by “CEO dominance”, not only shocked the conventional wisdom but it challenged the American insistence on using the vocabulary of democratic institutions to describe corporate functioning. The whole subject of corporate governance needs similar frankness if a system that lives up to the sound principles of accountable shareholder capitalism is to be created.

In Britain, the accountability of corporate boards – owing in part to the split between the chairman and CEO roles - is better than in America, while still falling short of what is desirable. The CEO, however, is still the dominant figure. Boardroom revolts are still very rare, and resignations of even a single director on a matter of principle almost as rare. Plus, when they go, they just go quietly in the traditional British manner, despite the Hampel Committee’s call for a public explanation.

In sum, the British system of governance and the greater accountability of its corporate boards may have something to teach America. But Britain still suffers from most of the same serious weaknesses and conflicts of interest, and it shares the same need for major reform.

Management remuneration abuse

Few subjects in shareholder capitalism attract more comment, most of it hostile, than the remuneration of CEOs and other executive directors. It is the ‘smoking gun’ of governance failure in both the US and UK.

High remuneration is defended as the necessary reward for the risk-taking and high performance on which growth, prosperity, jobs and pension benefits all depend – a natural and key part of market-driven shareholder capitalism. As a result, from the mid-1980s, remuneration has accelerated many times faster than average earnings to levels unrecognisable to the preceding generation. Pay is determined by remuneration committees, usually advised by the company’s remuneration advisers - who are appointed by the management which determines their fees. Such committees consist mainly of CEO-appointed CEOs of other companies, with a group interest in rising levels of reward. Investment institutions exercise almost no checks on behalf of their beneficiaries in America, and not many in Britain. For British remuneration (on average the highest in Europe, but less than America) to be justified - as it often is - by an appeal to American levels, is highly suspect.

Executive remuneration, while high in both countries (compared with rival nations or the past), could be at least partly justified if it reflected very high sustained corporate performance; but this is very far from the general case. There are almost no reputable studies in either Britain or America which have found any significant correlation between remuneration and corporate performance. There is, however, a close correlation with the size of companies (see below).

Since 1983, in both the US and UK, stock options have been by far the most important element in remuneration, massively larger than before. Unfortunately, they are a poor form of incentive – a risk-free, one-way bet. They correlate poorly with corporate performance, and if share prices

No correlation between remuneration and performance

Pricing and expensing stock options is important

fall they are usually re-issued at a much lower price. Option costs have not generally been shown in published accounts yet in America, but they now account for about 12% of issued shares. However, after the abuses of this year, it is likely that options will be costed in future, with the FASB and IASB leading the way.

The implications of this are significant. Many top American companies would be trading at a loss if stock options were properly costed. Reliable estimates of the impact on earnings range from 9% to 20% - and up to 70% in IT companies. A recent Federal Reserve study estimated that options meant large companies' annual earnings were overstated by 2½% during 1995-2000, and reported profits would have peaked in 1997, three years earlier than reported. These are major information distortions and almost certainly fuelled the stock market bubble – but Wall Street was silent.

This puts into perspective the embarrassingly self-serving response of the Business Round Table, an organization comprised uniquely of US CEOs, when FASB tried to require the value of stock options to be charged against earnings. Using its members' huge political power, the BRT forced the United States Senate (by an overwhelming margin) to direct the FASB to back down. FASB, with no independent basis of support, had no choice but to comply. This action, said Senator Fitzgerald at the Levin hearings, was the primary cause of the corporate value losses now affecting so many shareholders and beneficiaries.

Market forces were undermined by this, but investment institutions and analysts were silent. The British story is little better, but it matters less as options still comprise only 2%-3% of issued shares.

Transparency is insufficient for reform

Britain has its own dismal record of openness over directors' remuneration.

The 1995 Greenbury Committee wanted to show the full (but hitherto hidden, and often very high) costs of corporate pension fund contributions to directors' remuneration. Business and management organisations, fearing a 'fat cat' backlash, opposed disclosure fiercely and forced a compromise. Companies could choose between partial disclosure of relevant facts and full disclosure. Fears of adverse publicity (or hopes of credit for openness) were unfounded, however, because the investment institutions and their fund managers showed no interest either way in how companies reported. Little will change until institutions are *required* to protect their beneficiaries' interests. Information transparency alone will not overcome neutered governance structures.

Examples of excess

No instance typifies the 'kidnapping of corporate value' by top officers during a takeover more dramatically than the failed effort by WorldCom to acquire Sprint in 1999.

The Sprint option plan was designed to be triggered by any change of control, an almost universal condition in option agreements. Shortly before the announcement of the acquisition, which the entire US financial community realized would fail on antitrust grounds, the Sprint board changed the definition of 'change of control'. Henceforth, such a change would be deemed to occur upon a shareholder vote to approve a sale or merger *even if that sale or merger*

A litany of greed...

never took place. This was done during negotiations with WorldCom and without public disclosure. The acquisition (as was foreseen) failed - but the options vested and US\$1.2bn was extracted by Sprint executives. Many of the vested executives left the company immediately and business continued – exactly as before the ‘transactions’, except for the loss of money and personnel. This must be the nadir of correlation between executive compensation and shareholder value.

History will look back on the last decade of executive compensation in the United States as an atrocity.

The remuneration excesses went beyond mere numbers. Consider for example what the board of IBM did for its retiring CEO, Lou Gerstner. After a very successful, well rewarded (hundreds of millions of dollars) ten-year career at IBM, he was given US\$15m of restricted stock as a leaving present, a 10-year consultancy agreement with no specific duties or commitments, as well as 20 years of access to IBM aircraft, offices, apartments, medical insurance, tax and estate planning and free financial advice.

Similar arrangements were made in numerous other American mega companies - for example, GE awarded Jack Welch, on top of a US\$9m annual pension, about US\$2½m a year for life (though he has recently renounced this following adverse publicity) – and, on a reduced but still very lavish scale, for CEOs of lesser companies. In addition, failed managers in both the US and the UK are now routinely rewarded even when they are dismissed. Such practices, which encourage CEOs to take corporate risks while being well protected from any adverse outcome, are further evidence of a divergence with investor interests – and are the clearest possible indication of governance failure.

No discussion of controversial executive remuneration practices could exclude brief mention of the remuneration of Sir Chris Gent, CEO of Britain’s Vodafone, the world’s largest mobile telephone company.

No-one would dispute that so demanding a role deserves a high salary, given that Vodafone is a world ranking firm in a difficult, turbulent and volatile industry. But one can legitimately dispute the scale and incentives on top of salary. The cardinal principle for Vodafone and all other companies is that incentives should align closely with shareholder interests, i.e. to longer-term performance. There should be no additional rewards unless that criterion is met. It has not been met over the last three years in Vodafone.

Controversy began in early 2001, when Gent was awarded a £10m cash “transaction bonus” for winning a fierce takeover battle for Mannesmann, which made Vodafone Britain’s largest company. This bonus was denounced by the UK’s serious press since it was not tied to whether the transaction turned out to be a success. As a result, it was subsequently modified to half cash and half deferred shares. With the subsequent decline of Vodafone stock by around 75%, only £1.5m of shares were finally paid out to Gent this July. However, having also paid £13.4bn for third generation (3G) mobile phone licences, Vodafone has remained the target of sustained shareholder criticism. In addition to the huge fall in its share price, Vodafone has recorded a £13.5bn loss, the largest in British history.

Nevertheless, at this year’s general meeting, Gent was re-issued generous share options at the current price (now 75% less than at the time of the Mannesmann takeover). Institutional criticism was bought off by extensive consultations and some performance hurdles. As a result,

only one fund manager voted against – though the main serious newspapers remained highly critical.

The Vodafone story sheds an interesting light on the current state of Anglo-American shareholder capitalism:

- First, no mega company need fear an institutional shareholder revolt unless the company is close to failure. Automatic supportive proxy votes will see the directors through.
- Second, senior corporate managements will accept whatever incentives they are offered. They could, of course, honorably refuse excess rewards when shareholders suffer severely, but few do.
- Third, and crucially, the main performance incentives are flawed. Where the remuneration trigger is ‘earnings’, it is frequently earnings before interest, tax and amortization (EBITA) - a false measure which ignores major costs. It has, thus, encouraged many debt-financed takeovers that are not in shareholder interests. But neither conventional pre-tax earnings nor share values are satisfactory performance triggers either because both ignore the amount of capital required to generate growth. A better criterion, initially developed by Stern Stewart, is a company’s ‘economic value-added’. This takes earnings after deducting the company’s cost of capital. Stern Stewart’s figures for Vodafone showed positive results for 1997-99 - but for the last three years, the results have been dire (negative EVA of £2.5bn, £12.0bn and £9.6bn respectively).⁷

The need is for fully independent remuneration committees advised by remuneration consultants of their own choice, with no connection to the company’s management. (Otherwise the much canvassed option of putting CEO remuneration to a shareholder vote will not work.) This approach is far removed from that of virtually all major British and American companies, who can claim to be applying conventional best practice. When the overall system is flawed, ‘best practice’ comparisons have no place.

Most mergers benefit managers, not shareholders

Too many poor value mergers and takeovers

The efficient use of resources is a main pillar of capitalism. In efficient capital markets - *with strong corporate governance to protect shareholder interests*, and with wise guardianship of the public interest (for instance, avoidance of monopolies) - no generally valid criticism of mergers and takeovers can be sustained. However, in two particular cases, this general conclusion does not hold up:

- first, where a merger or takeover is promoted by management because managers benefit from the deal rather than shareholders; and
- second, where an underperforming management blocks a hostile takeover to protect its position.

Effective corporate governance could overcome this problem. Many Anglo American studies over the last 25 years have revealed that 60% or more of such deals actually destroy shareholder value, with shareholders in acquiring firms suffering the most. CEO incentives for short-term increases in share values (discussed earlier) drive this process. It is also driven by two other powerful forces:

- the understandable desire of fund managers to boost their own figures; and
- the huge fees earned by investment bankers (and other corporate advisers).

⁷ See Philip Coggan’s column in the *Financial Times*, June 4, 2002

Such incentives are perverse, given the destruction of real value. A February 2002 survey by KPMG Consulting of the largest international takeovers consummated at the height of the bull market showed that a third are now being unwound. Businesses acquired at great cost are being disposed of for fractions of their acquisition costs. Since that report was compiled the evidence has become even stronger. The firms where the greatest, indeed almost total, loss of shareholder value has occurred were serial acquirers of other companies – for instance Enron, Tyco and WorldCom. In these cases, high stock prices required continuous acquisitions. This ultimately unsustainable process was supported by compliant boards and often shady accounting practices. Understandably, global M&A activity has now slumped to the decade's lowest level.

Two investment banking reforms are long overdue:

- first, the huge banking fees and related bonuses need to switch from being entirely transaction-based to include some measure tied to the longer-term success of such deals; and
- second – as is beginning to happen in America – bank investment analysts must be entirely divorced from corporate finance business.

It should be a matter of major concern to investment banks that they have grown rich through these serious conflicts of interest, while helping to destroy so much shareholder value.

Auditors, consultants etc. Too close to management

The relationship between corporate managements and auditors, remuneration consultants and investment bankers are frequently unsatisfactory.

General audit considerations

The right of shareholders to elect auditors is a mere formality. Management nominates the auditors, and its decision is routinely approved. And as the largest auditors are now predominantly consultants (with consulting fees on average three times audit fees) there is a further conflict of interest since the two activities are inherently incompatible.

The major abuses have occurred in America, but the position is not satisfactory in Britain either. Accounting is an art as much as a science, and there is always some flexibility in agreeing costs, earnings, assets and liabilities. CEOs are under strong pressure to maximise earnings and minimize liabilities during their term of office. Auditors who are appointed and paid by management are inevitably subject to inappropriate pressures - which are often difficult to resist, particularly with high consulting fees also at risk. Too many American auditors succumbed. British auditors are not immune either - as the British chairman of Ernst & Young has publicly acknowledged.⁸

Audits are performed primarily for shareholders to provide an independent check on management stewardship. They are, however, equally important for lenders, creditors, investment analysts, and rating agencies. This means that, while consultants help managements to run companies better, auditors owe an *external* loyalty. The same firm cannot combine both roles and enjoy the full trust and confidence of the different parties involved - a logic which the global accounting

⁸ Nick Land, 'Collective failure and the debacle at Enron', *Times*, February 28 2002.

firms are finally accepting in America. Global market pressures may well result in a similar outcome in Britain.

John Biggs, the highly respected CEO of CREF, testified before the Senate on February 27, 2002 on the relationship of companies and auditors. It is noteworthy (but regrettable) that his principal recommendation, that companies should periodically rotate their auditors, was dropped from the much applauded Sarbanes/Oxley Bill, which became law at the end of July.

Many American managements and their auditors have behaved disgracefully in the last ten years. The failure to cost stock options – see above – contributed heavily to the corporate failures that have followed by giving CEOs a misconceived incentive to pursue growth regardless of shareholders' longer-term interests. Auditors went along with this as though it was a legitimate part of their job to help CEOs get rich. Auditors, particularly the largest, also began to offer high-value consultancy services. They pushed the flawed EBITA definition of gross earnings, rather than the properly conservative concept of net earnings, and they promoted *pro forma* accounts which relegated many costs and liabilities to footnotes. The top managements of some American companies, supported by their auditors, were thus issuing financial statements that they knew were without economic significance. The damage to stock markets from many years of 'constructed' earnings is as yet unquantified contingent liability.

Auditing remedies

The only remedy which can restore the full auditor integrity on which all financial markets depend is to split auditing from any potentially compromising consultancy work for the same client. The audit committee should consist of truly independent non executive directors who alone should recommend auditors to shareholders, with the authority to agree any additional fees for the investigation of anomalies or suspected fraud.

It is argued by accounting firms that such reforms will add significantly to costs - with the implication that they are unnecessary. This is both true and irrelevant. There can be no justification for misleading audited accounts. The damage to shareholders has been huge, quite dwarfing any cost savings. Further, it is not for either corporate managements or auditors to determine the appropriate costs for shareholder protection; that is for shareholders and independent audit committees.

Remuneration consultants

Precisely the same logic should apply to executive remuneration consultants. They too look to managements as their paymasters, since they usually advise on remuneration and incentives on a company wide basis. There is a clear conflict of interest if they also advise the remuneration committee on executive directors' remuneration and incentives.

The conflict of interest is as obvious as the remedy. Remuneration committees, comprised solely of fully independent non-executive directors, should be independently advised by consultants of their own choice. Such independent consultants will need to take a much more rigorous approach to value-added by management. It will no longer suffice to rely on comparative remuneration analysis with other similar firms.

**We must
split
auditing
from
consulting...**

**... and
remuneration
consultancy**

The need for relationship-driven investment bankers

It is of course entirely appropriate that a corporate management should choose the most appropriate banker to advise on takeovers or mergers since they are among the most critical decisions facing any company. However, given the fact that 60% or more of mergers and takeovers actually destroy shareholder value but can greatly enhance management remuneration, there is routinely a potential conflict of interest. Hence, when management wants to mount a bid, defend against one or propose a merger, it should have to make its case to the independent directors – who are going to need independent advice, and thus long-term relationship advisers who are free of conflicts of interest.

Such advisers should not have any other relationship with the company whose board they are advising. Their role is to evaluate objectively the advice of others, and they would deserve a substantial annual retainer.

The dangerous obsession with maximising shareholder value

Maximising shareholder value has long been accepted as the guiding principle of shareholder capitalism. But until 15 years ago, it was not regarded as the sole criterion - either by corporate managements or anyone else. It was accepted that corporations existed to serve the interests of society, and they derived their legitimacy from that object. Given that the earnings of shareholders (corporate profits) are the residual after satisfying customers, paying all costs, and obeying society's obligations, it was long held that profits could be maximised only by meeting the legitimate interests of all these wider groups.

This time-tested concept was then abandoned in favour of the view that companies exist to maximise a narrow conception of shareholder value. All incentives to managements, fund managers, and investment analysts now reflect this single criterion. Unfortunately, shareholder value is no longer viewed as long-term net earnings, but has been distorted by measures like short-term EBITDA. As a result, CEOs who do not achieve growth rates several times faster than GDP growth are widely regarded as failures - forcing them to embark on savage cost cuts, large staff lay-offs, the elimination of non-core businesses and endless takeovers and mergers. Customer service standards have frequently declined, suppliers are pressured to perform better for less, and employee morale suffers. Research and development, staff training and welfare, pensions, etc are also often cut back. Some of this undoubtedly helps efficiency, but much is destructive from any longer-term perspective.

The process was frequently carried to excess, as set out in a book by Allan Kennedy.⁹ He warned of the consequences of a single-minded pursuit of short-term share price maximisation. While applauding sustainable productivity improvements, he demonstrated that short-term share price maximisation mortgaged many firms' futures - a prophecy amply fulfilled in the years since he published. Kennedy particularly blames over-powerful, large company CEOs who pursue short-term earnings to maximise their share options. He presciently foresaw the formidable

⁹ Allan Kennedy, *The End of Shareholder Value*, Perseus Publishing, US: Cambridge, Mass. and Orion Business Books, London, 2000.

**EBITDA
leads
nowhere**

Realign management interests with long-term shareholder interests

challenge their successors would have regaining investor backing, restoring employee morale, securing stakeholder co-operation and overcoming political disquiet.

The clear need is to refocus CEOs and their senior colleagues to medium-term (say, five year) incentive packages geared to sustainable performance. Maximising shareholder value then necessarily embraces the legitimate interests of all the other parties whose long-term co-operation is vital to corporate success.

The need to realign interests with shareholders

The most compelling conclusion from the above analysis is the need to re-align the interests of CEOs and their senior colleagues with the longer-term interests of individual and beneficial shareholders.

All the other main parties involved – non-executives, auditors, investment institutions and fund managements – have (like corporate managements) grown rich over the last decade despite the fact that they have failed to serve shareholders’ best long-term interests. This is not because they are corrupt, but rather because they are beholden to corporate managements as the price of being in business. This is a *systemic fault*. They were unable simultaneously to look after the longer-term interests of shareholders – and, sadly, they forgot that it mattered.

Cushioned by the greatest share boom in post-war history, they comforted themselves that shareholders were also growing significantly richer by the year - justifying the unprecedented rewards to management and, of course, to themselves. There was talk of a “new paradigm”, and analysts predicted that the Dow Jones Industrial Average would rise to 36,000 or more and the FTSE 100 to an equivalent level. But, in the end, reality obtains: the brutal events of this year have shown that the neglect of basic duties is no longer acceptable.

The CEOs of mega companies became a race of superheroes. Inevitably, they began to believe this propaganda. Aware that most traditional checks and balances had been neutralized, they assumed even greater powers. True, if they did not deliver double-digit earnings growth, the markets would ditch many of them. But by then, with huge cashed-in stock options and generous compensation payments, they did not care. Indeed, many went on to repeat the process at another company. Any alignment of corporate direction with shareholder interests was coincidental and fleeting.

The clearest evidence for this mass delusion is the already mentioned experience with options in the US.

Eventually, the Federal Reserve and, then, the Securities and Exchange Commission approved the “cashless” exercise of options. First, shareholders would dutifully authorize the issuance of large numbers of shares on the board’s conditions (sometimes ignoring danger warnings by proxy voting companies). Then rapidly-rising share prices would make executives anxious to exercise those options to lock in profits. At that point, the machine went into high gear. Top executives were able to exercise their options *without putting up any money* – a ‘cashless exercise’ or free loan. Their companies usually had a general repurchase stock program, with the shares sold ‘off market’ to avoid any adverse price impact. We are told that Ken Lay, Enron’s CEO, ‘borrowed’ money from the company every day for several weeks, repaid by proffering shares back to the company – and that these ‘sales’ only had to be made public at year-end. Even more outrageous, a proportion of the option shares were converted into new

options at current market value (called ‘reloading’) – which, in a rising market, guaranteed endless wealth without any corresponding benefits to the company or its shareholders.

Britain equally needs corporate governance reform

Britain, with its generally superior accounting system and the almost universal split of the roles of chairman and CEO, has escaped the worst excesses of American corporate scandals. This has led many to assert, often smugly, that such conduct ‘could not happen here’. The claim is made that after the accounting reforms of the early 1990s, and after a decade of corporate governance reports resulting in a combined code of conduct consolidated under stock exchange listing rules, there is little more to be done. Accordingly, the government is warned to avoid a ‘knee jerk’ reaction to what is essentially an ‘American’ malaise.

While it is true that Britain has fared better than America, such reasoning is seriously mistaken. As we have argued, criminal conduct can be the result of a more generally unsatisfactory corporate governance system built on the six inappropriate powers of CEOs - all of which exist equally in Britain.

The checks and balances to make managements accountable are equally weak in both countries. Both suffer from the same damaging short-termism for CEOs and fund managers alike. Both have too few independent non-executives. Both have failed to link management remuneration to corporate performance,¹⁰ and have made stock options the main management incentive. Both have failed to control mega companies. Both have the same high proportion of poor value takeovers and mergers. In both countries, auditor independence is endangered by inappropriately large consultancy fees, and in Britain as well as America it is admitted that audit fees have frequently been used as loss leaders to secure or protect consultancy assignments. In both countries, investment institutions and their fund managers have been neutralised by the systemic fault. Equally, the evidence for the increased value of well governed companies and the small cost of achieving it are the same in both countries. And so we argue strongly that effective corporate governance requires the same reforms in both countries.

Moreover, while it is true that the UK has suffered little fraud to date, that misses the point. The overwhelming proportion of the massive and widespread loss of shareholder value in both America and Britain is due to unchecked corporate management excess, not criminal action. As well argued by Dan Roberts,¹¹ from an investor’s or employee’s perspective, ‘it can often make little difference whether the company is brought down by incompetence or greed’.

Finally, if it is true that America has suffered from more corporate excess than Britain, it also needs to be remembered that most US scandals have come to light from an exemplary number of continuing, prompt and thorough investigations. The Federal government and its agencies, the Senate and the House – as well as several state governments - have all been active. There have been no comparable British investigations into major losses of shareholder value (e.g. in telecommunications), and we ought to ask ‘Why?’. No-one can be sure of what would emerge from such investigations.

¹⁰ Recent past and existing CEOs of Glaxo SmithKline, Granada, Marconi, Logica, Vodafone, BT and Cable & Wireless amongst others, have all been strongly criticised in the serious press for giving poor value for money for shareholders

¹¹ Dan Roberts, ‘The Creeping Complacency’, *Financial Times* – 19 August 2002.

We conclude that there is no room for smugness in Britain. Business and financial lenders, investment institutions, accountancies, investment banks, the CBI and the Institute of Directors should all be asking what each can best contribute to restoring public and investor confidence in business integrity. The British government should remain as concerned as the US government to achieve major reforms. That alone will keep Britain internationally competitive.

The weaknesses in perspective

We have identified a considerable number of serious weaknesses in contemporary Anglo-American shareholder capitalism, and there may well be others. What is apparent is that not only are these weaknesses individually serious, they are also interdependent and damagingly progressive. The prime weakness underpinning all the others is undoubtedly the absence of effective, committed, knowledgeable long-term owners. Until that is effectively addressed, none of the other weaknesses can really be resolved. What is needed is to identify achievable remedies which are benignly reinforcing. Before taking a brief look at the best of the Anglo American remedies proposed by others, and then setting out our own comprehensive proposals, we consider the evidence that superior corporate governance is worth the effort to achieve it. The evidence is in fact strong that there are substantial, achievable and cost-effective gains for all involved.

**There is
a real
benefit
to good
management**

3. Well-governed companies are worth much more

Until this year, many, perhaps even most, managements regarded governance as at best a fad and at worst a time consuming nuisance, distracting management from its main task of achieving shareholder value. There is, however, persuasive evidence that well governed companies are both less risky and worth more, sometimes very much more, to their shareholders and everyone else associated with them. One finding stands out: Companies where directors invest a significant sum from their personal resources - and have to hold the shares for appropriately long periods - outperform the others. As GE's Jack Welch put it, 'stock ownership changes behaviour'.

We begin with the incontestable evidence of the last year or so that the absence of good corporate governance can lead to large losses of value.

Avoidable massive value destruction

The last two years have seen the destruction of shareholder value on a scale virtually unparalleled since World War II. It occurred mainly in the high-tech industries. First were the 'dot.coms', most of which lost over 90% of their peak trading values. Next, with total losses ten times as large, were the telecommunications companies, probably the largest asset bubble in history with US\$1 trillion of debts worldwide. Many of the worst accounting practices were in this industry. The most prominent British case was the former British GEC, renamed Marconi. Not allowing for asset distributions, its stock price fell by over 99% from its peak market value of less than two years ago.

The most spectacular corporate failure, however, with the most far-reaching consequences in either country, has been the fall of Enron, once America's seventh largest company. Its value dropped from over US\$70bn in late 2000 to bankruptcy a year later. Similar (and in some cases

even larger) falls in value have occurred at WorldCom, Tyco and Global Crossing, all of which had questionable accounts. When such companies began their spectacular growth, few critical voices were heard. Shareholder protection was largely absent.

Even if there had been better governance, there would probably still have been a bubble. But, with powerful and effective owners plus fully independent and diligent non-executive directors, the rise in share values would not have been as great, there would have been far fewer poor value mergers and acquisitions, and far greater financial transparency. Most of the companies concerned would have survived – albeit at lower values – and investors would have been better off.

The non-executives of such failed companies have been widely criticised. They exercised few sceptical checks on CEOs, and the companies' eventual failure seemed to surprise them as much as everyone else. But (as many commentators have noted) numerous other parties – including auditors, institutional investors, fund managers and investment banks - must also share the blame for strongly supporting corporate actions to raise short-term share prices which proved to be unsustainable. Conventional approaches to corporate governance have largely failed to hold senior managements accountable to shareholder interests. The negative evidence – that poor corporate governance contributes significantly to the destruction of shareholder value (and to blight many others in the process) – is indisputable.

Reducing avoidable corporate waste

There are two significant forms of waste in inadequately governed companies, both touched on earlier. First, there is no perceptible link between the remuneration of senior managements and sustainable corporate performance. Investors have supported very high remuneration for proven long term performers, such as Lou Gerstner at IBM and Jack Welch at General Electric. But relatively few senior managers enjoy such patient support to demonstrate their real capabilities. The remedy – well supported by studies – is both longer tenure (with suitable safeguards tailored to particular industries) and payment largely in shares which must be held for (say) five years even if dismissal occurs earlier.

The second main source of avoidable waste is linked to the first one. Sixty percent or more of mergers and takeovers destroy shareholder value - but enhance senior management rewards (which correlate closely with size rather than performance).

The twin approaches of longer term, genuinely performance related pay, and the avoidance of conflicts of interest in mergers and acquisitions would overcome much of the present avoidable waste which so damages investors.

Benefits of committed ownership

Few institutional investors even try to be long-term *owners* (as opposed to long-term investors), i.e. to take a direct and strong proprietorial interest in the companies in which they invest. Instead, they invest in a very widely spread, constantly adjusted, portfolio of shares. They aim to optimise their portfolio's overall risk/return balance, and have little contact with individual managements, save in a rare crisis. Hence, their returns tend to fall within a narrow range since their portfolios are similar to those of their competitors.

In contrast, a minority of highly selective investors achieve significantly higher returns with concentrated portfolios of say 10-20 shares. Such concentrated portfolios allow investors to know their companies and management well, and to have a sufficiently large holding for influence (often including a seat on the board). Warren Buffett, through Berkshire Hathaway (BH), is the most celebrated exponent of this strategy. BH takes large committed positions in a dozen companies whose businesses it understands and which it expects to perform well long term. Buffett usually becomes a director – and is highly welcomed by managers and other shareholders. BH’s shares usually trade at a premium to the underlying holdings, a rare distinction. Further, and crucially, Buffet negotiates favourable terms for his investment and expert board participation. Typically, it is a convertible preference share on favourable conversion terms if the stock appreciates significantly – and, with his involvement, it usually does.

The BH approach illustrates two critical governance points:

- first, long-term commitment and portfolio concentration permit deep knowledge of a company and its strategy - usually leading to longer-term returns well in excess of widely-spread portfolios; and
- second, shareholders welcome board membership by significant investors to secure the benefits of superior long-term performance and stability from active, knowledgeable, committed, long-term owners.

Two of the most compelling American examples of the value of effective shareholder involvement in governance are the saving of Salomon Brothers by BH, and the extraordinary resurrection of Waste Management Company under the leadership of Ralph Whitworth of Relational Investors.

Positive evidence

The case that well-governed companies are worth more is supported by a lot of positive evidence. There is a growing body of academic work demonstrating that superior governance can significantly increase corporate value and reduce the risk of corporate failure. For instance, a 1999 study of nearly 400 companies in 27 countries found that the better investors were protected, the higher the value they would put on assets.¹² A major shareholder exercising power responsibly on behalf of all investors raises share values; a narrow, selfish shareholder reduces them.

Impressive supporting evidence also comes from studies undertaken by McKinsey over seven years from the mid-1990s. The latest and most comprehensive study, conducted in April/May 2002, covered 31 major countries through the Global Corporate Governance Forum. It looked at 200 investors, who with their parent organisations had US\$9 trillion under management.¹³ The survey showed that 70-80% of investors would pay a premium for a well-governed company, defined as having:

- a majority of outside directors, truly independent, i.e. no ties with management;
- directors with significant shareholdings;
- a material proportion of stock-related pay;
- a process of formal director evaluation in place; and
- a responsive attitude to investor information requests on governance issues.

¹² R LaPorta, F Lopez-de-Silanes, A Schliefer and R Vishny, “Investor protection and corporate value”, NBER Working Paper 7403.

¹³ Paul Coombes and Mark Watson, Global Investor Opinion Survey Key Findings – July 2002, *McKinsey & Company* at www.mckinsey.com/governance

Reap the premium

The survey shows that governance remains a great concern for institutional investors, one on a par with financial indicators when evaluating investment decisions.

McKinsey's work acknowledges that, while it remains difficult to measure the market price impact of the premiums that investors say they will pay for well-governed companies, there is little doubt that good governance does feed through. This is a powerful argument for reform. It is much strengthened by the widespread acceptance that corporate governance is a priority in both the US and UK. Without it, confidence in equity investments will remain fragile. Major government-sponsored enquiries are under way in both countries, and the US has recently implemented the Sarbanes-Oxley Act.

McKinsey's surveys also found strong evidence that institutional investors want better accounting disclosure, the expensing of stock options (80% support), more independent boards, better director selection, proper board evaluation procedures, and a greater time commitment from non-executives. Most importantly, those surveyed supported the need for more government involvement.

In sum, numerous recent studies show widespread business and political support for corporate governance reform in the US and UK, given the clear benefits to all concerned. Significantly larger benefits still would flow from the highest standards of corporate governance – including knowledgeable, committed long-term owners. Serious research makes it clear that a majority of investors now considers governance issues on a par with financial issues, a finding strongly supported by non-executive directors. Quantification of the gains from good governance shows that reduction of risks and the potential rewards are high, compared with the modest costs involved – and are anyway essential to restore public and investor confidence.

We next consider very briefly the remedies that have been proposed by other bodies in the US and Britain, before setting out our own comprehensive proposals.

4. Previously proposed third party remedies

On so important a topic as corporate governance, there have been many major British reports in the last decade, but few American ones. Now, the crisis of the last six months has increased the pace of major investigations - this time, with America leading the way.

Despite the many changes recommended over the years, their overall impact has been relatively small. The major weaknesses identified above, particularly absentee ownership, largely persist. The reason is that the underlying premise of most investigations has been that companies are being run in the interests of shareholders – who have sole responsibility for putting any shortcomings right. The effective neutralisation of shareholder power, the excessive power of corporate management, and the general failure of the main checks and balances have gone largely unrecognised.

The main British initiatives

The 1992 Cadbury Report was the first, best and most influential. It put corporate governance firmly on the UK business agenda. It recognised the general desirability of separating the

chairman and CEO roles, the importance of effective non-executive directors, and the need to set up board committees (audit, remuneration and nomination) mainly of non-executives, as well as the rotation of audit partners. It also generally encouraged investment institutions to take an interest in board appointments. The resulting split between the top two corporate roles and tougher accounting standards have, most people feel, saved Britain from the type of scandals now evident in America – which is a real achievement.

Greenbury - hard-hitting

The 1995 Greenbury Report addressed public and government concerns over executive remuneration. It was a hard-hitting paper, covering the most pertinent points, but its effect on the inexorable rise on remuneration was negligible. It insisted on transparency in the high cost of senior management pensions, but the revealed costs were largely ignored by investment institutions. Transparency alone, without fundamental reforms, is clearly insufficient.

Hampel - starry-eyed?

The 1998 Hampel Report was consolidatory. It concluded that ‘... public companies are now amongst the most accountable organisations in society’. It recognised few conflicts of interest, and felt that shareholders already had sufficient power for any needed reforms. Its most important recommendation was that companies should have regard to the public acceptability of their conduct.

All three 1990s reports contained good sense, but they ignored the problems of effective implementation.

Some progress was made in the government-sponsored Company Law Review of 2001. This recognised that the role of investment institutions is a matter of public interest, and that they should be active and responsible in the exercise of shareholder power. It also accepted the need for better regulation.

The other major UK investigation was the Myners Report on institutional investment, also completed in 2001. This recognised that corporate managements should be held properly accountable to shareholders, and that investment institutions must look after beneficiaries, despite conflicts of interest. Its proposals have been criticized as ignoring the intractable nature of the conflicts of interest involved. But the government has rightly accepted the general thrust of its recommendations, as do we.

The main American initiatives

US came later to the problem

The main US initiatives are entirely a product of the last six months, when the President, Congress, the Justice Department and the SEC have all conducted major reviews and insisted on major reforms. These largely take the form of:

- tougher criminal penalties for securities fraud;
- establishing a powerful accounting oversight board;
- restricting the consultancy services of auditors; and
- requiring CEOs and CFOs to certify financial statements.

This is by no means the final word on American corporate governance reform. The good intentions of these initiatives are not in doubt. But, as yet, they do not take in just how effectively all the parties who are expected to provide corporate checks and balances have been neutralized. Nor do they address the corrosive effect of short-term pressures on CEOs and fund managers alike and general systemic weakness. But public trust in the integrity of American

business has been so shaken that more reforms are inevitable, and it is to aid this process that this paper is put forward for both countries.

5. Comprehensive proposals for effective reform

A four point reform programme

Owners are the best guarantors of their interest

It has long been recognised that no one looks after other people's assets as well as they do their own. The need is to move from the *rhetoric* of giving primacy to longer-term shareholder value to making it a reality in a socially acceptable way commanding public trust. This requires the alignment of management and institutional interests with those of individual and beneficial shareholders. The present conflicts of interest would never be tolerated in politics. They should no longer be tolerated in business, where most of the retirement savings of America and Britain are subject to significant avoidable risk and damage. Indeed, such is the current public and political mood in both countries that major changes are inevitable. The challenge is to ensure that the changes realistically address the main problems.

The existing law governing trustees and fiduciaries in the US and Britain already explicitly requires that they act solely in the interests of their beneficiaries for the exclusive purpose of providing them with benefits. But this law has not been enforced in either country; nor have there been penalties for inaction. What is required is not so much new law as the enforcement of the existing law on pension fund trustees, life insurance company fiduciaries (in fact, on their boards of directors) and, by implication, on the boards of mutual funds, and unit and investment trusts.

Our clear preference is to enable owners to look after their own interests by removing the handicaps which presently prevent them. As we have shown, it is impossible for owners – or their intermediaries, or self regulation, or market forces – to overcome the serious systemic fault. An effective external catalyst is needed, and that catalyst can only be government.

Every credible critic of government action – from Smith and Locke to Hayek and Friedman – agrees that government must set standards (and secure compliance) for the public good, and discourage actions for public harm. Government involvement is now clearly needed in corporate governance to guarantee citizens the rights of ownership of their major assets, stocks and shares. Prominent business leaders (such as Hank Paulson of Goldman Sachs and Sandy Weill of Citicorp) have spoken eloquently to the same effect. To this end, we believe four modest but effective actions are necessary. What is needed is a clear and consistently enforced public policy. It must give all owners' representatives (the intermediary investment institutions and their fund managers) the clear fiduciary requirement to be active with respect to companies held in their portfolio accounts – and the confidence that they will not be placed at a competitive or disadvantage by complying. Above all, it must be clear that governments will enforce trustee and fiduciary laws (as they should) for the “sole” purpose and “exclusive” benefit of their beneficiaries – that is, most citizens with funded pensions - in an even handed way.

Our four proposals are as follows:

- Governments should affirm, in support of the principle that there should be no power without accountability, that creating an effective shareholder presence in all companies is in the national interest – and that it is public policy to encourage effective shareholder involvement in the governance of publicly-owned corporations. A national-level Council should be created to ensure that this policy is applied by all executive and judicial branch agencies, competition authorities, stock exchanges and other entities.
- All pension fund trustees and other fiduciaries (insurance companies, mutual funds) holding shares must act solely in the long term interests of their beneficiaries, and for the exclusive purpose of providing them with benefits.
- To give full effect to the first two proposals, institutional shareholders should be made accountable for exercising their votes in an informed and sensible manner above some sensibly determined minimum holding (US\$15m/£10m). Votes are an asset; accordingly, they should be used to further beneficiaries’ interests at all times. In effect, the voting of all institutionally-held shares would be virtually compulsory.
- To reinforce the other three proposals, shareholders should have the exclusive right and obligation to nominate at least three non executive directors per major quoted company. (Such Wall Street figures as the financier and former Ambassador Felix Rohatyn and the much respected governance counsellor Ira Millsten have recently suggested that direct nomination of at least a single director should be considered.)

Crucial interdependence of the proposals

These proposals are both necessary and mutually reinforcing. In our opinion, they would create a *market* demand for effective ownership and governance:

- The general statement of government support for an effective shareholder presence is more than justified by the evidence that well governed companies are both less risky and worth much more to shareholders and all other involved parties. Government endorsement is also necessary to create public trust, to ensure that all parties understand public policy, and to guarantee that all agencies of government will support the policy. With equities comprising the largest category of personal assets by far, nothing less than effective accountability should be acceptable to the main political parties of both the US and UK.
- The requirement for all trustees and fiduciaries is equally critical. While it can be argued that this is already the law, it is almost universally neglected *without penalties*. It needs to be given specific, continuous and strong public emphasis to overcome inertia and conflicts of interest i.e. to make all trustees and fiduciaries proactive in the sole and exclusive interest of their beneficiaries. Corporate governance cannot be a spectator sport.
- Without being *compelled* to vote, institutions might well not face up to the risk of active engagement with managements. Unless all are required to act, too many are likely to take the soft option – which would undermine the whole reform process. To be compelled to vote, but without the requirement to do so solely and exclusively in the interests of beneficiaries, would also be likely to result in institutions taking the line of least resistance. There would be, as at present, an almost automatic vote in support of nearly all management proposals regardless of merit. It would, thus, give the spurious appearance of democratic accountability, while leaving the reality of the double accountability deficit intact.

**Go with
the
market...**

- Requiring shareholders to nominate at least three non executive directors is crucial to get indisputably independent accountability into the heart of every boardroom. As with non executives now, the majority of such independent shareholder-directors should be chosen from the pool of experienced businessmen and professionals. Indeed, they would be unlikely to attract sufficient support from either individual or institutional shareholders if they were drawn from any other source. The crucial difference would be that the shareholder-nominated directors would be free of *any* implied obligations. The record of all too many failed companies has shown that the appointment of independent non executive directors endorsed by *all* Anglo American enquiries, commentators and the financial press is far too important to be left solely to executive directors who have conflicts of interest. Nor would such shareholder-nominated directors be divisive. They would be concerned to show their colleagues that they are committed to the success of their company. The management-appointed non executives would be equally concerned to demonstrate that they too are independent. We believe that this is one of the most necessary of all corporate governance reforms because it ensures, *for the first time*, that shareholders can participate effectively in the choice of a critical mass of truly independent non executive directors. (It is routinely asserted that the majority of management appointed non-executive directors in both countries are already ‘independent’; this has not prevented the many evident corporate shortcomings and failures.) All that our proposal amounts to is making a partial reality of what is presently, but wrongly, claimed to be the universal position, namely ‘...that shareholders elect the directors.’

Immediate benefits from implementation

We need real governance

This paper has focused on the key corporate functions where “real governance” is essential if accountability is to be effective. There are many ways in which the necessary changes could be effected through a combination of compulsory shareholder action and the strengthening of regulation and company law. Clearly, a substantial new commitment of time, energy and resources is contemplated for shareholders, but this should not be viewed as an additional burden. Rather, it is a restoration of the cost-effective ownership function to its original concept. Nobody ever passed a law to say that ownership would be stripped of responsibility. Its dilution was unintentional, a by-product of other priorities.

In no respect do we suggest intrusion on the essential limited liability of those who hold equity securities. Individual shareholders neither have nor should have any legal obligation to be activist. We, however, are addressing the specific situation in which controlling equity shares are held *in trust*. We are strongly urging that the law of trusts be applied with respect to this asset, and that trustees be required to inform themselves and to take whatever action is necessary to preserve and enhance the value of portfolio companies. Once all are required to be active, the costs and risks of *individual* action fall away.

So long as owners were flesh-and-blood human beings with at least substantial minority holdings, their own self-interest could be counted on to provide appropriate surveillance over corporate conduct. As the unintended consequence of measures to boost individual retirement provision, ownership was transferred from human beings to legal constructs – to pension and other trustees. These legal constructs had no concept of ‘self interest’ on their beneficiaries’ behalf. Thus, the critical balance of human monitoring has gradually disappeared from the governance

of the modern publicly-held corporation. Our proposals would restore the traditional equilibrium by enforcing shareholder responsibility in specific areas.

At present, as set out earlier, chairmen/CEOs and their senior management colleagues have six inappropriate powers, giving rise to serious conflicts of interest at the very heart of Anglo-American shareholder capitalism. Our proposed reforms would deal with all of them:

- Senior managers would no longer choose all of their ‘independent’ non-executive colleagues – a minimum of three would be nominated exclusively by shareholders.
- They would no longer choose the auditors - it would be the responsibility of the independent non-executive directors’ audit committee to recommend the auditors to the shareholders, probably on rotation, and the auditors could perform no other service to the company. The audit committee would have a proper budget, including provision for any investigations it deemed necessary. (This reform, which we have long advocated, is now becoming public policy in America, and will probably be required in Britain.)
- Senior managers would no longer appoint the remuneration consultants to the non-executive remuneration committee. Rather, the committee would choose its own independent consultants who could perform no other service to the company.
- They would no longer have the ability to neutralise the corporate governance responsibilities of pension fund trustees. The trustees would be required to meet their full legal responsibility of working solely in the interest of their beneficiaries with regard to all companies in which the pension fund holds shares.
- Senior managers would lose their power of patronage over their pension fund’s fund managers, since whichever managers were chosen would be legally required to work solely and exclusively for the fund’s beneficiaries.
- They would have to allow non-executive directors independent legal and financial advice on all significant mergers and takeovers – and accept that the non-executives have an obligation to advise shareholders directly. Not to do so would be to flout the legal requirement to act in shareholders interests in an area where there are often conflicts between the interests of shareholders and managements.

The removal of the six inappropriate powers that have gradually been acquired over many decades would leave corporate managements free to concentrate on their prime responsibility of achieving sustainable longer term performance for all individual and beneficial shareholders – for which they should be appropriately incentivised (see below).

Effecting change

There are several necessary supporting actions to make sure our proposals are effective in providing a solution to the inappropriate powers of corporate managements, and to overcome damaging short-termism:

- After decades of neglect, there needs to be a committed regulator (perhaps the Financial Services Authority in Britain and the SEC in America) to ensure that trust and fiduciary law will henceforth be enforced. It is bizarre that intermediaries should be tightly regulated as to their honesty and competence in dealing with their investments, but be under no practical obligation to ensure that valuable shareholder rights in the companies in which they invest are actively and efficiently discharged on behalf of the beneficiaries.

- The fund management contracts of pension fund trustees and other fiduciaries should normally be for a longer period of, say, five years (subject to safeguards), to encourage fund managers to take a longer-term view, to adopt a wider variety of investment strategies and to play to their long-term strengths. This would clearly be in investors' interests.
- It is equally desirable that directors should increase the expected tenure of CEOs, subject to appropriate safeguards, to longer than the present 3-4 years (or less). CEOs and their senior management teams could then develop longer-term policies where appropriate, and play to their own presently neglected longer-term strengths.
- Independently advised non-executive remuneration committees will need to give CEOs and the rest of senior management generous incentives for longer-term corporate performance. This should include a significant annual grant of restricted shares (*not* options), realisable only when some appropriate value-added benchmark is passed. Most of such shares should not be realisable for an appropriate period (say five years) which matches the longer-term interests of most underlying investors.
- Finally, non-executive directors should be paid substantially more, since they would have greater responsibilities and would need to devote more time to the job.

Possible market responses

**... and then
the market
will produce
its own
solutions**

If the measures we have recommended were implemented by the US and UK governments, it would mean that investment institutions and their fund managers would have to provide active committed long-term ownership on behalf of their beneficiaries. Since conflicts of interest with corporate managements would still exist, many institutions would probably choose to provide that by sub-contracting ownership responsibilities to disinterested investment intermediaries.

This means that the introduction of effective corporate governance would generate a demand for new skills and services as institutions and fund managers set out to discharge their new obligations. (The systemic fault presently prevents the emergence of any market demand for such services; once an economic demand exists for such services, market forces can be relied upon to meet them efficiently.) How they respond would be a matter for individual decisions. But, while it is not possible to predict the outcome in detail, it is useful to outline some possible reactions.

It is important to appreciate that the new obligations that we propose would not automatically overcome the present conflict of interests. Fund managers, life insurance companies and mutual funds, as well as investment and unit trusts, will still want to retain corporate clients and attract new ones. As the new obligations are inescapable, however, they will have no choice; they will either have to discharge those obligations directly, or delegate them to new investment intermediaries who do not have their conflicts of interest. (An interesting precedent was set by Barclays' Patricia Dunn; as a director of Hewlett Packard, she resolved a recent conflict of interest with respect to voting Barclays' shares by delegating responsibility to Institutional Shareholder Services, a special purpose proxy firm.) Some large insurance companies, public sector pension funds and activist investors will take the former route – as they do now. But they will have to do it continuously and across their whole portfolios. The majority of institutions will prefer the latter route. To meet the new demand we foresee the emergence of 'special

purpose trust companies' (SPTCs) – and probably also 'specialist investors' (SIs) and 'relationship investors' (RIs).

Special purpose trust companies

The purpose of an SPTC would be to meet the new compulsory obligation to vote the shares in the portfolios of its clients. These clients would be the great majority of investment institutions, who would prefer to delegate their voting responsibilities into disinterested competent hands rather than be subject to conflicts of interest between their beneficiaries and corporate managements. SPTCs would represent a *competitive market solution* to the new and inescapable corporate governance requirements. Their appointment, fees, and indeed their very existence, would depend on offering a valued commercial service for the new governance obligations, in full competition with other providers.

Specialist investors and relationship investors

The emergence of SPTCs – in combination with new governance obligations and a regulator – could well be enough to ensure sufficient accountability such that nothing further would be needed. But other new intermediaries could emerge if SPTCs were not sufficiently effective or because of the additional benefits they could offer. In particular, we suggest that two other entities might emerge - 'specialist investors' and 'relationship investors'. Both would be based on the benefits that can be achieved by concentrated investment portfolios holding shares for the longer term and seeking board representation (like Warren Buffett's Berkshire Hathaway). They would own a sufficient shareholding for a long term investment in a small portfolio of companies, and would seek to discharge an ownership role. Unlike SPTCs, they would put up candidates to be shareholder directors for their fellow institutions to vote on.

"Specialist investors" (SIs) would, in effect, be specialist investment trusts aiming to hold 4-5% shareholdings in perhaps only eight to 10 companies – enough for influence but not dominance. They would charge fees, with a major performance-based incentive. They would have small but experienced staffs, made up of successful business executives and investment analysts. Their function would be to select a small portfolio of companies for long term investment and to act as supportive and knowledgeable long term owners, discharging the full corporate governance duties which would then be mandatory. This is broadly the strategy of Ralph Whitworth's Relational Investors, whose successful preservation of value for WMX constituents was noted earlier.

"Relationship investors" (RIs) would be similar to SIs, but more suited to the requirements of fund managers, who would be the ideal candidates to organise them as an additional service. Their purpose would be to pool all (or at least most) of the core shareholdings in larger companies held by a number of fund managers. These pooled (but still minority) shareholdings would have far more power and influence than the separate funds. Further, and crucially, the core shareholdings could be held for the long term, despite any turnover in fund manager clients or

portfolios. Like SIs they would seek (say) 3-5% holdings in major companies, enough for influence but not dominance. They would discharge all governance duties on their holdings, and could put up non-executive director candidates. They, too, would represent a competitive market solution for the discharge of effective governance. Hermes Focus Asset Management has already organised funds in the UK, Europe and the US which provide guidance in this area.

6. Conclusions

Anglo-American shareholder capitalism is prevented from currently delivering its optimum performance by strongly entrenched weaknesses and by the short-termism imposed on corporate managements and fund managers. Together, this comprises a major systemic fault. It is the unintended and unforeseen consequence of the decline of influential shareholders, who aligned the longer-term interests of owners and managers, and their replacement by essentially passive institutions who lack the incentives to hold corporate managements accountable. As a result, power has gradually been relinquished to such managements – who have inevitably used it for their own gain, often at investors’ expense. Furthermore, managements have gained undue power over auditors, investment institutions, and fund managers.

The current governance system in both the US and UK is riddled with serious conflicts of interests which would not be tolerated in other walks of life. A decade of investigations and reports has produced little real change; checks and balances are usually in evidence only after a company and its shareholders have been severely damaged (as in the cases of Marconi and Enron).

Savers around the world are all looking for a way to invest through which they can earn the highest return at an acceptable risk. The common stock of publicly traded companies provides such investors with a particularly attractive blend of reward and risk – but only so long as they feel that the market is honest. Corporate governance is about providing this assurance. Only if investors are convinced, first, that they are making a decision to buy based on reliable information and, second, that management is running the enterprise for their benefit, will the market value stocks attractively.

Many studies in both the US and UK have demonstrated that equity investment normally outperforms other categories of investment over the longer term. Hence, for 40 years, equities have been the main investment of choice for all forms of retirement – both by individuals and, more important, by investment institutions on behalf of their beneficial investors. The bulk of these beneficial shareholders are employees saving for retirement. With the investment risk of pension provision passing increasingly to employees (and with the expected fall of equity returns from the high levels of the last two decades), it is no longer politically acceptable to tolerate the largely passive absentee ownership practices of pension fund trustees, institutional investors and their fund managers. This is particularly so when the potential gains from companies subject to real governance are, as shown, so significant and would dwarf the extra costs involved.

At present, there are almost no competitive market forces that push investors towards real governance, despite the significant potential gains. Market power is not absent, but it takes the form of seeking short-term performance because the assured tenure of institutional shareholders (particularly their all-important fund managers) is itself short term. The institutions have become

**Get rid of
the
conflicts of
interest**

traders of shares, rather than owners of companies. The critical value-creating ownership role, therefore, goes by default.

What is needed is to free all the main parties – corporate managements, investment institutions and fund managers – to play to their undoubted longer-term strengths, and for them to be well incentivised to do so. It should no longer be possible for any of these entities to prosper unless they serve shareholders well.

Investors, individual and institutional alike, have always looked to boards of directors, particularly non-executive directors, to safeguard their interests. The record shows that far too many of those directors, all chosen by incumbent managements, have been inadequate protectors. Even Alan Greenspan has scathingly dismissed the conventional wisdom that so called ‘independent’ directors could or would ensure acceptable corporate governance. Britain, with the fairly general split of roles between chairmen and CEOs, has a better board system than America – but it is still a far from adequate one. In the US, at present, there is no chance of a board that is independent of CEO power unless and until there is a damaging (and often fatal) crisis. The July 2002 Congressional hearings, chaired by Senator Levin, are thus remarkable for making clear the need for a board chairman who is separate from the CEO – yet this issue was not addressed in the Committee’s Report.

In both the US and UK, boards cannot continue to be based on the lie that shareholders are meaningfully involved in the process of their selection. Some form of effective owner participation in selecting non-executive directors is an inescapable requirement.

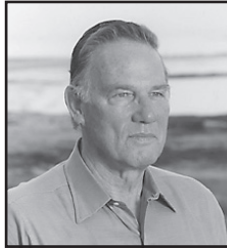
Corporations are ultimately a system of power. The principal concern of governance must, therefore, be how to minimise adverse consequences of abuse of this power. Governance is about creating a framework within which a skilful management can create value. Governance does not create value; but it is vital to help assure a structure that both promotes it and that prevents the needless destruction of value.

In this survey of Anglo-American shareholder capitalism, we have argued that shareholders need a working system of effective property rights. The direct and beneficial ownership of shares is by far the largest class of personal assets, but most shareholders are not able to exercise their rights directly. Their representatives, therefore, need to be incentivised to provide an effective countervailing power to hold corporate management accountable to shareholder interests for demonstrable gains. As de Tocqueville observed, ‘The vote is worth little without the institutions to make it continuously effective’.

It will be said that institutional investors do not want to be actively involved as owners of publicly traded companies, and that they are presently not trained to fulfil this function. But once the law of trust (which governs fiduciaries) is enforced, plus the other three complementary reforms put forward, these objections fall away. There would then be a strong *market* demand for new entities to act as owners through effective and well rewarded intermediaries which all beneficial investors need for their protection and prosperity. And, if there is one thing we can be sure of about capitalism, it is that market demands will be efficiently and competitively met. The practical problems of a system that, at present, is based on excessive management power compels us to the conclusion that capitalism, without informed, motivated and effective owners, will not long survive.

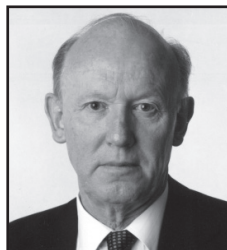
We need owner participation to save capitalism

We have set out a comprehensive set of integrated proposals for achieving such effective ownership. What is proposed is neither more nor less than Margaret Thatcher's government achieved with regard to trade union reform in the UK – a reform which was an essential part of Britain's 1980s economic recovery. Mrs Thatcher effectively returned the rights of trade unions to the members by means of compulsory secret ballots for strike actions – and, thus, made the unions accountable solely to their members' interests. The members of companies, the shareholders, deserve the same treatment. What we are proposing would deliver the same huge benefits to members and nations alike. Anglo-American shareholder capitalism could thus have the brightest of futures.



Robert A G Monks

Robert Monks is one of America's most prominent corporate governance activists. He is also a prominent lawyer, businessman and a former US Department of Labor pensions fund regulator. He founded LENS, the institutional activist investment fund, in 1992, and has since developed a partnership with Hermes in the UK. Robert was the first to identify corporate directors, particularly non-executives, as the pivotal balance between the interests of managements and their shareholders. He is the author of four best selling books on investment and corporate accountability. His latest book, *The new global investors – how shareholders can unlock sustainable prosperity worldwide* was published in Britain and America last year.



Allen Sykes

Allen Sykes, a former managing director of Consolidated Gold Fields, has held senior positions in a number of major international companies, particularly in the capital intensive industries of mining, energy, natural resources and transport. He has also held a number of non-executive directorships. He was co-author with A J Merrett of the influential best seller *The finance and analysis of capital projects* which was a pioneer in the introduction of modern financial and risk analysis techniques. He is the author of *Capitalism for tomorrow – re-uniting ownership and control*, published in July 2000.

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