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Institutional Investors As Owners Conference

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KEYNOTE SPEECH

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First let me thank NYU for sponsoring this conference, and all the outstanding panel participants who will give it substance. I also thank Citigroup for creating the Fellowship which sponsors me this year, succeeding Arthur Levitt who was last year's Fellow in Ethics and Business Leadership.

The terms of the Fellowship require that I organize a conference related in someway to ethics and business leadership, a rather broad and open-ended mandate. I think the importance of corporate governance in American public companies is clearly related to ethics and business leadership. And I would also say that the complex and rapidly evolving role of institutional owners will see a great deal of attention in future years, and raises profound questions about American corporate governance.

The terms of the Citigroup Fellowship also requires that I give a keynote address, presumably at lunch, during this conference. Given who agreed to participate, two of the leading figures in corporate governance, Roel Campos, Commissioner of the SEC and Marty Lipton, the bar's creative and intellectual leader in corporate law, I thought it wise to give them the place of honor. You will have to endure my so-called keynote comments, briefly this morning.

I am reminded of a recent experience at the Council on Foreign Relations when I was chairing a small seminar on monetary policy with an interesting speaker from Latin America. To our surprise, Paul Volcker joined the seminar, sitting just opposite me. a privilege of the CFR seminars is for the Chair to ask the first question.

As the opening speech finished, I looked across the table to see a very long arm over Paul's six foot eight frame, lifted to ask a question. I decided quickly to forego my first question privilege. Similarly today I give it up to Roel and Marty.

Corporate governance is a huge subject. The small part of it related to institutional investors has been a particular interest of mine, beginning with my years at TIAA-CREF in formulating that institution's corporate governance strategy.

A provocative book published a decade ago by Mark Roe used the title Strong Managers, Weak Owners. Professor Roe focused on the political history explaining why American banks, insurance companies, mutual funds and pension plans were prevented by law from becoming large block investors. His book primarily defined weak ownership as fragmented ownership. Because of federal and state law prohibitions, we have few large block holders who could offset the power of strong managers. He did not describe the American model as necessarily good or bad, contrasting it with the German and Japanese corporate models that did have strong ownership, empowered by a tradition of financial institutions with large blocks of equity interest.

The current critics of corporate governance in America would expand on Professor Roe's title stating that our governance situation is better described as "strong managers, weak boards and passive owners."

The case is easy to make for this critical view if one focuses on the recent corporate failures, frauds and misuse of corporate assets by imperial CEO's or, more broadly, the disturbing failure of boards to check excessive and abusive executive compensation. See Lucien Bebchuk on a detailed, comprehensive view of executive compensation abuses and his draconian proposals to correct them.

However, from my own experience at TIAA-CREF and serving on several corporate boards, I would argue that our boards have been significantly strengthened. Ken Langone on the opposite side to the critics, claimed that this strengthening of boards will lead to American companies being, in his words, "the best governed and worst managed companies in the world."

Clearly we want both strong management, and strong boards. I would argue that most of the recent regulatory changes have strengthened boards without fundamentally weakening management. For example, involving audit committee in more direct oversight of financial reporting clearly strengthened the board, had little effect on the careful CEO's authority. For those CEO's who use financial reporting for disguising results, it has a very desirable weakening effect. Board compensation committees need to be energized and we can hope this will begin to deal with abusive executive compensation – this was a cause long advocated by TIAA-CREF during my years. We made little progress until Congress, the New York Stock Exchange took up the issue. Even the Business Round Table sees this as an important board function with appropriate limitation on senior management who tended to control the process in the absence of clear board leadership.

On the other hand we should avoid reforms that are designed to simply weaken the American CEO model, a centerpiece of American strong management. Peter Drucker's recent essay in the December 30 Wall Street Journal describes the broad role of the American CEO, as an American invention with no real counterpart in any other country and fast becoming a major U.S. export.

Take one example, of a reform that substantially weakens management, the insistence by many that the best practice for all companies is to separate the Chairman and CEO roles. Advocates of this best practice frequently admire the British model where the CEO position is relegated to the role of our American Chief Operating Officer, called usually the President and COO.

Sir Adrian Cadbury's eloquent book on British governance describes the non-executive chairman's role in defining corporate strategy, overseeing capitalization, dealing with external relations, and, of course, controlling agendas and information flows to the board. Clearly the so-called CEO in such a regime is known here in the U.S. as the COO, receiving direction from the Chairman. Sir Adrian quotes favorably the comment that the company marches to the drumbeat of the Chairman – not the CEO.

Clearly forcing the separation inappropriately on a company weakens management, creating possible conflicts, making decisive action to redirect a company much more difficult – consider Lou Gerstner and IBM. In other companies, the separation may make sense, on a temporary basis or even permanently (as in a non-profit fund raising organization). Instead of forcing this as a best practice, we should let strong boards make the decision

Enough on strong management and strong boards.

The main thrust of my remarks will focus on the passive owners.

You may wonder what I mean by owner passivity.

Let me give one simple proof of broadscale institutional passivity. Proxy voting is the least expensive way to express opposition to board or management behavior. It is significant and extraordinary that, to my knowledge, no bank trust department, no life insurance company and no mutual fund company has ever sponsored a proxy resolution that was opposed by the board or management of a public American company. TIAA-CREF has done so, and of course, so have the public pension funds and labor unions.

The arguments for passivity are powerful, in fact, but have rarely been stated openly.

I can think of only two exceptions. Bob Pozen wrote an essay in the Harvard Business Review entitled *The Reluctant Activist*. And I remember the head of a major indexing firm (not Vanguard) saying his company's mission was the lowest possible cost

for investing and, accordingly, it would be inappropriate for them to spend money on monitoring individual companies.

Obviously because of the lack of large block interests in the U.S., we have a serious free rider problem. Few investment institutions own as much as 1% of a company's stock, so if they succeed in some way in improving an individual company's performance the vast majority of the benefits go to other investors.

There are further explanations for a private institution's passivity. First there is the Wall Street rule, that still rides supreme. If you do not like management or the board, sell the stock. Or if you are an index fund manager, you do not know anything about an individual company.

The costs of competent activism are high. Direct costs are not significant since one or two competent lawyers, or economists or accountants or investment analysts can make up an excellent advocacy team. On the other hand, organizing a responsible and thoughtful activist program requires the direction, and most importantly, the commitment of the most senior management. It is a strategic initiative.

Furthermore, the short term and transient nature of most active investment programs give little incentive to think like a long term owner – if you expect to hold a stock for less than a year, you clearly do not want to waste time on influencing the governance of the company. Such efforts have uncertain benefits and requires a very long-term horizon.

Average holding periods for New York Stock Exchange stocks are now less than eleven months – NASDAQ not even that.

Somehow, between the SEC, the Exchanges and our companies, we have made a decision to spend billions on increasing the speed and ease of trading but little on improving the governance of our public companies. We subsidize day traders while we are reluctant to improve the fundamental structure of governance. Huge amounts of money were spent a few years ago moving the settlement dates from five days to three days – yet our institutional investors implicitly conclude we cannot afford two or three people to oversee a corporate governance program.

I have spoken before the boards of several universal banks, suggesting ways they might become activists without inflicting enormous damage on their client relationships. Jack Grubman said, infamously, "conflicts of interest are synergies." In our complex investing institutions are inevitably "dysergies."

The case we made for becoming a corporate governance advocate at TIAA-CREF rested on the long-term interest of our professors and other higher education employees. Clearly we believed that owning stock in public companies, US and foreign, should be an important part of how they would accumulate funds and achieve better returns in retirement. Shouldn't we, as well as other institutional investors do whatever we could to improve the overall performance of those companies - i.e., shouldn't we act like long term owners of that part of the American economy that could best enhance

returns to those future retirees? Admittedly a long-term view. We take the risk that others would free ride without contributing to the effort. On the other hand, if we focused our efforts well, might we achieve at least enough to pay our full costs.

Let me give some examples of how institutional investors have been historically passive, when an activist role might not involve them in direct confrontation with their clients/customers.

I have been involved for about twelve years in the oversight of the accounting profession. First as a trustee of the groups overseeing the standard setters – both FASB and the IASC. I was also a member of the now defunct, private sector overseer of the American auditing profession – the little known Public Oversight Board, happily replaced by the new federal regulatory agency, the PCAOB created by Sarbanes-Oxley. Interestingly, the provisions of Sarbanes-Oxley relating to auditors were largely based on the recommendations of the Public Oversight Board made in our final report as we all resigned in protest against the amazingly near sighted view of the then big 5 auditing firms and the Chairman of the SEC, Harvey Pitt.

The strange non-connect in all my audit oversight experience was the extraordinary and wide based lack of interest in financial principles setting, auditing standards, and financial reporting practices by the entire professional investment community. There were very few exceptions.

Yet all the accounting and auditing groups talked continuously of "what do investors need." Investors, or "users" more broadly, rarely engaged in telling the standard setters what they wanted. They did not know, in fact. It was almost impossible to find users who would sit on the standard setting boards, or even on the trustee level oversight boards. And asking investment institutions to voluntarily supply financial support was a non-starter. I know from long personal frustration.

A result of this lack of response is an unfortunate but understandable arrogance on the part of the standard setters to presume to know what users wanted. On the other hand, the preparers, i.e., CEO's and CFO's of public companies, representing strong managers, were always engaged, well informed and very vocal. Just consider the current international brouhaha with the French banks and the IASC attempt to require them to record changes in the market value of their derivatives.

One of the elements of the TIAA-CREF programs was an effort to engage the standard setters in conversation. Meeting with researchers, employment of a former FASB standard setter, etc., were obvious ways to energize our process. Standard setting is complex. But if you are responsible for investing 100's of billions in stocks and pay huge amounts of money to active managers, wouldn't it be wise to spend a little on an accountant or analyst whose job was to improve the infrastructure of investing.

Also wouldn't financial support of improving the infrastructure of investment be an appropriate, and non-controversial, form of activism for a major investment firm? The most we ever asked of major firms was $200,000 a year, but we were told that "would affect my bonus", would "provide information to everyone that we now individually

access otherwise." Of course, there were a few far-sighted exceptions, especially among the universal banks.

Another form of activism is to support professionals who understand anti-takeover provisions and can single out those that are not legitimate. Professor Roe points out how massively institutional investors, who had an interest in preserving the market for corporate takeovers, were defeated in the 80's and early 90's when state laws were pushed by home state companies with no effective opposition from national money managers. Strong management won easily against weak and passive owners.

Institutional investors were silent and passive during those debates – but strong managers were focused, vocal, active and strong. And they won.

Another example of weak ownership. Opposition from strong managers to expensing stock options is well known. Strong managers direct huge amounts of money and time to influence Congress on this issue. The managers of trillions of dollars of investor assets have been utterly silent and passive. Why? A few would be criticized by their client base if they spoke up, but not in the same way as if they filed a hostile proxy.

A very few of such investors may have believed that expensing options is not a good idea. The vast majority, I am sure, with no research to prove it, strongly endorsed the FASB attempts to change the standard. But Congress heard nothing from anyone in the investment community. (I was one exception, arguing primarily that Congress should not interfere with FASB's process.)

Another strange example of investor passivity. The most significant piece of legislation in the last 25-50 years affecting public companies was the Sarbanes-Oxley bill. Many testified pro and con in the Senate Banking Committee hearings on the auditing and corporate governance aspects of this law, but to my knowledge, there were no institutional investors who spoke up. Knowing enough to speak up was not trivial. But those earning billions of dollars in managing other people's money might have devoted some resources to "knowing enough".

Let me conclude this brief and incomplete listing of how well informed private sector investment management firms could play a role in becoming engaged owners.

Peter Drucker for many years has predicted the coming of pension socialism In America, as pension plans come to own a majority of the voting stock of American companies. Perhaps his prediction is now being realized, but in a very perverse way.

First, there is no question that state and municipal pension plans are activists. They represent government employees. Calpers and, certainly, Alan Hevesi, have been in the news frequently as powerful advocates of interests of government employees.

Secondly, the AFLI-CIO has finally realized its powers and is strengthening its staff resources to be smart advocates for their governance agenda.

Thirdly, effective social agenda activists such as ICCR and Amy Domini are asserting their voting power on a range of social issues.

And, fourth, of course we have the Gilberts, Evelyn Y. Davis and John Shevedden adding color to our annual meetings, representing their own personal agendas.

Can we never expect the great financial services firms and investment management companies to represent the private sector with comparable vigor? These firms have the most talented analysts and investment research capacities. Their motives are economic and constructive, if they will only assert themselves.

It is hard to predict a strong corporate governance culture with strong managers and strong boards without engaged owners.

I hope this conference might awaken some of the private sector energies and show the way toward constructive engagement.

Thank you.