

# **Positioning Pensions for the Twenty-First Century**

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## Chapter 8

# Corporate Governance and Pension Plans

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Robert A. G. Monks

... the large funds are beginning to learn what Georg Siemens, founder of Deutsche Bank and inventor of the Hausbank system, said a hundred years ago when he was criticized for spending so much of his and the bank's time on a troubled client company: *If one can't sell, one must care.* (Drucker 1991: 318, emphasis added)

Institutional investors, especially pension funds, are the largest holders of equity securities. This chapter discusses what their role should be in the governance of the companies in which they invest. In the past, their involvement has been indirect, through the buying and selling of shares, but their very size now makes it almost impossible for them to beat the market—they *are* the market. More and more, they are “indexed,” that is, invested in the market as a whole, rather than in a selected group of portfolio companies.

In light of evidence about the “value” of shareholder activism, this “permanent holder” status gives institutional investors additional opportunities as well as additional obligations as fiduciaries obligated to act “for the exclusive benefit” of the beneficial holders, which is best effected by evaluating ownership options with the same focus and risk-benefit analysis traditionally used in making buy-sell decisions. As a matter of law, ability, and policy, they cannot become involved in “ordinary business,” but they can improve corporate value by encouraging governance structures that promote accountability and therefore responsiveness to the market and competitiveness. A number of possible models for shareholder involvement in governance are proposed.

## Pension Fund Equity

Pension funds make up 48.1 percent of institutional capital in the United States and 29.6 percent of the total outstanding equity.<sup>1</sup> The pension system as a whole owns such a large percentage of the total equity capital of the country that "selling" its holdings is no longer a feasible method for dealing with underperforming companies. As of the end of the third quarter 1994, the pension systems aggregated US \$4.6 trillion of assets, of which US \$1.18 trillion were public funds, US \$2.51 trillion were private trusteed funds, and the balance were managed as insurance assets; 43.8 percent of the assets of private plans and 48.7 percent of the assets of public ones were invested in equity.<sup>2</sup> Institutional investors owned 51.5 percent of the total outstanding equity and 55.8 percent of the equity of the 1,000 largest United States corporations at year end 1993. By mid-1994 the five largest institutional investors owned 11.2 percent of the largest 25 companies (Brancato 1993, 1995).

## Defined Contribution and Defined Benefit Plans

There are two categories of pension plans with regard to benefits. The first, with a rapidly shrinking plurality (45.3 percent of assets) is the "defined benefit" plan. In these plans, the employer is committed to a specific payout, no matter what level of contribution is made by the employee and no matter what the performance of the investments. The employer, whether corporate or government, bears the risks; to an extent, the employer is guarantor of a specific defined benefit. In defined contribution plans (42.4 percent of assets), on the other hand, the employee bears all the risks. 40.1 percent and 32.1 percent of plan assets are invested in equities by defined benefit plans and defined contribution plans respectively.

In each type of pension plan there is an incentive to achieve superior investment results. The plan sponsor of a defined benefit plan, whether public or private, clearly wants to reduce its obligation to make additional payments into the pension scheme. Defined contribution beneficiaries are entitled to those funds comprising their plan assets, so the incentive to maximize values is personal and direct.

Obviously, everybody cannot achieve "superior" results. This has resulted in an increasing percentage of plan assets either advertently or de facto being invested in "index" funds that match the market's performance. Some have argued that the exercise of ownership rights, including voting proxies, becomes less important in an indexed fund because there is no commitment to hold the stock. If the company is managed

badly, the stock will fall, and the index formula will require that it be sold—a self-activating variation on the Wall Street rule which says that investment managers should vote with management or sell the stock. Others have argued that, as a matter of economics, index fund managers cannot compete by taking an active interest in voting the shares. The costs of evaluating each proxy issue will outweigh the return to investors because index fund managers who do not vote will become free riders, benefiting at no cost to themselves from the work done by those who exercise the ownership rights. Those who do not incur the costs of exercising ownership rights will be more competitive by charging lower fees because they do not provide the additional service of active proxy review, although the returns are the same.

On the contrary, a fiduciary whose trading choices are self-activating must avail itself of every other mechanism, whether through the proxy system or a shareholders' derivative suit, to protect the assets it manages for others. In fact, index fund managers have a greater obligation to monitor and analyze proxy issues than managers of other funds. Indexed funds provide no discretion for asset managers with regard to trading. Index fund managers do not have the option of selling the stock if they do not agree with management's proposals; they must wait until it sinks far enough to fall off the index. Studies have shown that the adoption of devices that entrench management depresses share value. Therefore, to ensure the maximum return to shareholders, the asset fund managers acting as fiduciaries must vote against their adoption and for shareholder proposals to rescind them. Certainly a fiduciary cannot stand by and allow a firm in which it holds shares to siphon off corporate assets with no return in value to beneficiaries just because the mechanism used is the proxy vote rather than cash.

But, indexed or not, institutional shareholders can act against their interest when they are presented with options that benefit each of them marginally while harming the group as a whole significantly. They will accept the economic harm because, under the current proxy system, shareholders do not work together to maximize the return to all of them. It is thus clear that shareholders, by working together, can work to the benefit of all of them, and it is clear that failing to do so will work to the detriment of all of them.

Fiduciaries are obligated to act, actively and diligently, in the interests of those whose trust they hold. They are obligated to be on notice of others similarly situated and, by common action, lower their costs. As the institutions become larger, the free-rider problem diminishes. Furthermore, if this obligation is clearly understood, either through a regulatory or judicial interpretation of the fiduciary standards or through adoption

of industry requirements by an organization like the Council of Institutional Investors, there will be no free-rider problem. Institutional investors, both indexed and managed, can work together to hold corporate management accountable to ensure that corporate management gives shareholders, the plan beneficiaries, the highest return.

Public and private plans have many similarities but certain important differences. For purposes of this paper, the one important difference lies in the tendency of plan sponsors to dominate administration of private plans, whereas public plans are more apt to function in a political mode.

### **The Role of the Government**

The commitment of the state (or its subdivisions) to pay a "defined benefit" is in most cases guaranteed by the state constitution. Whether or not there are adequate funds in the pension trusts, the state is obligated to make the promised payments. Funding of pension systems is essentially a matter of intergenerational fairness, and public defined benefit plans are designed with the intention (though not always the reality) that the generation that receives the benefit of services pays the taxes to provide the pensions related to those services. Therefore, decisions about the appropriate investment policy for pension assets are essentially political because in the final analysis the electorate should decide on the levels of risk and reward thought appropriate for one time period or another.

The commitment of corporations to pay defined benefits is ultimately guaranteed by the federal Pension Benefit Guarantee Corporation (PBGC). But, in the first instance, it is promised and collateralized by the assets of the "plan sponsor" employer corporation. A medley of considerations underlies the investment policy of private companies. They can pursue high risk policies (in the manner of the airlines and steel companies in the 1980s) knowing that the PBGC will ultimately "bail out" the beneficiaries, or they can pursue the "conservative" path of assuring that their actuarial returns are achieved and the corporation has the highest assurance that it will not have to divert more than the planned payments into the system. Lawyers and courts can and will argue which alternative more closely achieves the statutory mandate that all trust assets be managed "for the exclusive benefit" of plan participants.

### **Investment Horizons**

In general, plan sponsors, both public and private, benefit from maximum long-term growth in pension assets. Plan participants benefit to the

extent that funding of their benefits requires decreased commitments from employers or taxpayers.

A common stock-based investment policy for pension funds raises two separate problems. First, there are drawbacks to public ownership of private enterprise. Pension fund holdings of common stock are viewed as "back door socialism." This is especially problematic when it leads to politically based initiatives from public pension funds that are unrelated to (or even contradictory to) economic returns. Some examples have included South Africa divestment and bailing out insolvent city governments. Second, active management—market timing, industry choice, stock selection—has not been able, over time, to produce consistently better results than those of the market itself (Ellis 1989; Nesbitt 1992, 1994). The level and profitability of fees to managers, consultants, trustees, custodians, and all manner of service providers to the pension industry is so high that it eliminates any advantage of active management and creates conflicts of interest that make it virtually impossible to receive unbiased advice about investment alternatives. The "indexation" of equity holdings is therefore as a policy and an investment matter compelling for public plans<sup>3</sup> and competitive for private ones.

Public funds are entirely funded by taxpayers, and private plans, significantly subsidized through tax incentives, are thus funded by the taxpayers as well. Because it is the taxpayer who is at risk, it is not only appropriate but essential for government to assure that the funds are administered consistent with the public interest. This particularly includes the responsibilities of pension fund trustees as owners of portfolio companies.

## **Pension Plan Fiduciaries in the United States**

Public plans are administered subject to the laws of the sponsoring state. Private plans are regulated by the Pension and Welfare Benefit Administration (PWBA) of the United States Department of Labor (DOL) under the Employee Retirement Income Security Act of 1974 (ERISA).

Trustees of public plans are either appointed by a designated political official or they are elected by a particular constituency of plan participants; trustees of private plans under ERISA are appointed by the plan sponsor. In both cases, pension funds are administered by trustees who are subject to the highest standard of care developed by our legal system, the fiduciary standard. The fiduciaries of public and private pension plans have an unenviable role. By law and tradition they cannot personally benefit from favorable consequences through incentive payments and bonuses (with some exceptions), but they can be held liable for un-

favorable ones by being fired (if they are in-house), losing the account (if they are outside), and even being prosecuted if there is an allegation that fiduciary duty has been violated.

ERISA requires fiduciaries to consider only the interests of plan participants in their decisionmaking—not their interest as employees or members of the community. But this provision has not been administratively enforced or judicially defined with sufficient conviction to mitigate the crippling conflict-of-interest problem that hobbles trustee behavior. Fiduciaries under ERISA are subject to strong industry pressures in the performance of their duties, and it is clear to individual and institutional trustees that their continued employment is at the discretion of the plan sponsor. To the extent that they exercise their discretion in a manner perceived as inimical by plan sponsors, they can be sure of not being reappointed and of being “blacklisted” for new business by other employers.

The trustees of public plans do not need to fear commercial reprisal, but they are subject to political pressures (Romano 1993, 1994). Although on occasion public plans such as Public Employees Retirement System of California (CalPERS) have been willing to oppose the managements of local corporations, including Occidental Petroleum and Lockheed, this is a very rare exception.

While the pension system as a whole “owns” almost one-third of the total equity in the United States, no individual plan has sufficiently large holdings to make it economically rational to find and pursue opportunities to increase the value of portfolio companies through the use of such shareholder activism initiatives as shareholder proposals, withholding votes for director candidates, or proxy contests (all with significant attendant costs of soliciting support). For example, TIAA-CREF and CalPERS, the largest pension systems, each hold approximately 1 percent of the total market equity. For either of them to take the lead as shareholder activists means that their beneficiaries bear all the costs of failure and stand only to be rewarded with 1 percent of the gains. This “collective action” or “free-rider” problem challenges the question of trustee prudence. It certainly presents an unattractive alternative to the individual fiduciary who personally cannot benefit from the fruits of his or her decision, but can be adversely affected if such a decision is unsuccessful as an investment or as a political matter.

United States employee benefit plans have almost no system for informing and being instructed by plan participants. ESOP plans often provide that the trustees will administer “ownership rights (tendering, voting)” in accordance with the instruction of beneficiaries, but there are a number of issues that make that process complicated. In one case, for example, “Bank of America was supposed to administer the plan ac-

according to the sole interests of the [Carter Hawley Hale] stockholder-employees. But it was simultaneously in the active, highly paid service of CHH management with a life or death interest in seeing that the shares of the plan were voted against the tender offer" (Drucker 1976:92). Given the perverse incentives for pension beneficiaries to refrain from becoming actively involved in monitoring corporate management, no matter how great the failure, enormous conflicts of interest create an all but insurmountable obstacle.

### **An Ownership-Based Economy**

"Ownership" of the commercial sector of the economy by the approximately 100 million Americans having beneficial interest in the various public and private employee benefit systems provides a stable and "legitimizing" base for the power exercised by the leaders of the vast business aggregations. As Peter Drucker said, "Pension Fund Socialism should make it possible for management to regain legitimacy precisely because it re-establishes a genuine, socially anchored ownership" (Drucker 1976:92).

The pension system represents a financial foundation for public corporations that is both widespread and long term. Furthermore, pension fund "owners" have interests exactly congruent with those of the overall society; they are the overall society. Drucker notes that "The shift to the pension fund as a radically new kind of 'owner' is a truly profound change in social and economic power and structure . . . the shift is far too great a challenge—equally great as a threat and an opportunity—to wait for accident or insurgence. How the United States responds will largely decide whether it faces rapid decline as both an economy and a society" (Drucker 1991).

### **The Pension System as "Owner"**

The owners of large, publicly held corporations cannot make "ordinary business" decisions. They have no right to do so, and they have no expertise in these areas. Even if they did have the right and the ability to become involved, they would have conflicts of interest with almost any company, as they invariably hold at least some of its competitors, its customers, and its suppliers. Shareholders elect the board, which in turn hires management to perform these functions. Likewise, owners should not interfere with those questions appropriate for boards of directors. If board questions are not being appropriately addressed, the remedy is through replacement of the board.

The fact that the role of shareholders is limited does not mean it is

unimportant. Owners should organize themselves to have the expertise necessary to evaluate portfolio companies and to determine the appropriate level and form of their involvement. Many, indeed most, of the holdings of pension funds may be perceived as performing so well that the only involvement required by shareholders is thoughtful voting of the proxy. When owners determine that change is necessary, owners are obligated to commit the resources to be informed, to deal directly with management (in the very rare cases where discussions are not availing) to determine what kinds of individuals are needed for the board, and to nominate and elect these new board members. This means, of course, that they must also commit the resources to be able to determine when their involvement is appropriate or, in other words, "a good investment."

There will be situations where the "emergency" intervention of owners is necessary. These will occur when monitoring is inadequate, but even with the best system of prevention circumstances will inevitably arise requiring immediate and direct attention. One such example was the direct involvement of the "blue chip" shareholder of American Express to force out Jim Robinson as chairman in 1992 after the board of directors had approved a succession scheme confirming him in that role.

During the past decade, owners have begun to create a structure of cooperation with other owners. This is of particular importance as a way of mitigating the classic "prisoner's dilemma" collective choice problem, whereby otherwise appropriate shareholder initiatives are not pursued because, while doing so would benefit all shareholders, only one or a small group have to pay all the costs. The Council of Institutional Investors has been very effective in providing a way for large institutional shareholders to share information and resources and develop responses to issues like stock option accounting and legislative and regulatory proposals, but its ability to underwrite and organize company-specific initiatives is limited. One useful model for these efforts is used in the development and operation of huge energy projects and venture capital investment, where the parties will act as "managing partners." Over time, this permits a "fair" sharing of the "ownership" burden, all the while assuring that a motivated and highly competent management is actually doing what needs to be done.

Based on this model, I submitted a shareholder resolution (Appendix 1) at the Exxon Annual Meeting of 1993 calling for the creation of a shareholder advisory committee comprised of the holders of large blocks of stock. Because it provided that the company would pay the modest expenses of the committee's meetings (including the costs of the requisite information), this approach was designed to provide a way for

shareholder involvement without unfair allocation of the expenses of "ownership responsibilities." The proposal received a small but significant vote (8 percent), and has since been submitted by other shareholders at other companies. While some companies have voluntarily agreed to the formation of some kind of shareholder committee, none has been created yet as the result of a shareholder proposal.

The problems of "commercial reprisal" for private fund trustees and "political reprisal" for public fiduciaries can only be solved through a government commitment that pension fund responsibilities transcend all other considerations despite the strong temptation to use pension money to solve other economic and financial problems. Without effective and evenhanded enforcement, however, this message will not be received. A vigorous and visible enforcement effort will remove the burden from those many trustees who want to carry out their statutory responsibility but are inhibited by competitive commercial realities. To the extent that government "draws a line in the sand" and puts all on notice of the priority of fiduciary obligations to beneficiaries, pension fund trustees can begin the process of becoming effective owners.

### **Value Added Through Shareholder Activism**

Similarly, options for shareholder activism —vigilant exercise of ownership rights, ranging from careful evaluation of proxy issues to submission of shareholder resolutions and solicitation of support from other shareholders, to a proxy contest for one or more board seats— should be evaluated by fiduciaries and law enforcers on strictly economic grounds. Empirical data are beginning to be evaluated by consultants and academics. For example, Wilshire Associates and the Gordon Group are consultants who are retained by clients who are themselves "activist investors." It is, therefore, neither surprising nor convincing that both should assure CalPERS that its activist commitments have been beneficial to plan participants. Academic studies like one by Sunil Wahal are more equivocal, recognizing that there have in fact been relatively few examples of shareholder activism and that no orthodoxy has emerged as to an appropriate way of measuring its impact. A recent and extensive survey by Wahal (1994) of activism by nine public pension plans over a seven-year period (1987 to 1993) concludes:

Targeting announcements are associated with a small but significant wealth effect for a subset of firms. However, there is no evidence of improvement in the long-term stock price performance of targeted firms. In fact, performance continues to decline even three years after targeting. Moreover, in contrast to other institutions, pension funds do not appear to significantly reduce their holdings in

underperforming firms in general, or in firms that they target. Collectively, the results cast doubt on the effectiveness of public pension fund activism as a substitute for an active market for corporate control. (Wahal 1994)

Another study by Gillan and Starks (1995) reaches a similar conclusion:

We examine whether institutional investor activism by public pension funds is effective in achieving its stated goal of increasing shareholder value. An investigation of the short-term stock market performance indicates that, during certain periods, there are significantly positive abnormal returns surrounding the targeting of firms for governance reform. In contrast, in any analysis of long-term stock market performance we do not find evidence of statistically significant positive returns. This leads us to question the overall effectiveness of this form of shareholder activism. (Gillan and Starks 1995:2)

### **Activism by Public and Private Pension Funds**

These studies are particularly useful in making clear what is reasonable and what is unreasonable to expect from public pension funds. Public pension funds are governed by trustees who are either elected directly or appointed by elected officials. They are therefore sensitive to politics. They will be most involved in "fairness" issues and will be limited by concerns about "overreaching" by government as well as more particular concerns about their involvement with companies that have local connections. Public pension funds, therefore, are well situated to raise "fairness" issues, like management entrenchment, excessive compensation, and other areas of corporate governance. Beyond this, they are limited. They are led most often by people with backgrounds in government, not in business. Their own compensation does not increase as a result of initiatives that enhance shareholder value. Their political sensitivity can lead to initiatives designed more for political gain than for investment returns. Only continuing pressure will create change in targeted companies, and the adverse risk/return ratio for public trustees' activism makes such constancy improbable. Public funds have been and will continue to be invaluable leaders on a limited range of issues and allies for activism initiated and maintained by others on a broader range.

Another way of understanding "reasonable expectations" for public pension plan activism is to consider how much they spend and what they purchase. By and large, the entire expenditure of public plans consists of two items: the time and expense of key personnel, and items that can be purchased with "soft dollars."<sup>4</sup> Great discretion is needed in the use of soft dollars because of the omnipresent fear that the state legislature will decide to exercise control over these public funds. The highly publicized initiatives of CalPERS frequently amounted to the time and travel expense of CEO Dale Hanson, General Counsel Rich Koppes, and some

home office back-up plus a variety of consulting services, limited to those that happened to be eligible for soft-dollar payment. For political and budgetary reasons, no money was ever spent for outside proxy solicitors, advertisement, or the panoply of professionals needed for a full-scale shareholder effort, and victory was declared on the basis of small steps forward. For example, CalPERS issued widely publicized corporate governance "report cards" for the 200 or so largest companies in 1994 and 1994. The grades were based on the responses to their requests for the boards to consider and react to the corporate governance guidelines issued by General Motors. The grading system was very process oriented. Anyone who did not respond got an F; any company that did respond fully to the letter from CalPERS, noting that their board had reviewed the GM guidelines and discussed them, got an A. One company, whose response was signed by every director, got an A+. The grades were not in any way based on the substance of the companies' governance provisions, only their willingness to raise the issues and inform the shareholders that they had done so.

As for the private pension funds, it is pertinent to consider Peter Drucker's prescient warnings of two decades ago:

The new institutions that we have created—the pension funds and their "assets managers," who administer and invest the pension moneys—must have adequate management and be legitimate. Further, they must represent the beneficiaries and bear a clear-cut relationship to them. The pension funds have to be autonomous institutions. . . . By and large, however, the corporate pension funds have not yet even begun to organize themselves for either accountability or legitimacy. These new institutions must be free from any suspicious of conflict of interest. They must be set up to serve their beneficiaries and no one else. . . . What matters is that being both commercial banker and pension fund manager puts the bank into an inherent conflict of interest. . . . Pension funds are much too important to be run as a side line, which is all they can or should be in a commercial bank. Pension fund management requires and deserves an independent institution. (1976:85–87)

Twenty years later we are no closer to beginning to answer the question. As a result there is no shareholder activism emanating from the private pension fund system.

### **"Relationship Investing"**

In a sense, all investing is "relationship investing," but the term is most often used to describe the involvement of a significant shareholder. One form, epitomized by the great investor Warren Buffett, has demonstrated massive positive returns from appropriate shareholder involvement in the governance of the companies in which he invests. In several cases, he

or one of his colleagues joined the boards of directors. In the case of Salomon Brothers, he stepped in to take over the day-to-day operations of the firm to save it from going under entirely.

A different form is exemplified by our own LENS fund. Before LENS began, the companies in which we had become active consistently underperformed the market averages. Following our initiatives, LENS, investing in very large companies—Sears, American Express, Westinghouse, Eastman Kodak, Scott Paper, Stone & Webster, and Borden—achieved annual total returns approximating 23 percent over a period when the S&P index has done only half as well. The characteristics that LENS marshals in aid of profit are our own money, our business backgrounds (which make it possible for us to select portfolio companies that can be changed and develop the recommendations for change), our commitment, and our unwillingness to be distracted. And yet we could not achieve these results without the support of many of the public funds and private money managers. We had an explicit working arrangement with CalPERS in 1989 in successfully opposing Honeywell's effort to amend its charter to provide for staggered directors' elections; CalPERS and several other prominent institutions publicly supported our initiative with Sears Roebuck. In other cases, we were able to obtain a broad base of support by communicating our concerns to the shareholder community. Companies with confidential voting<sup>5</sup> give us the opportunity, at affordable cost, to secure up to 45 percent of the total vote for shareholder resolutions. This has given us credibility and leverage with both the shareholder and management communities.

A number of developments have made it easier to obtain support for shareholder initiatives. For example, in 1992 the SEC amended the rules governing shareholder communications. Until that time any communication to more than 10 other shareholders had to be reviewed, edited, and approved by the SEC before it could be circulated. The revisions to these rules sharply decreased the costs (and the risks) of activism. The increase in the adoption of confidential voting, most often at the urging of shareholders, has limited the real and perceived problems of commercial and political reprisal.

### **Pension Plan Impact on International Corporate Governance**

Pension plans in the United Kingdom, the Netherlands, Canada, and Japan as well as the United States are becoming massive investors in the equity securities of companies outside their borders. The liberalization of investment restrictions all over the world has conferred economic and political power on those countries having liquid investable funds.

Countries such as France without a funded pension system have belatedly recognized their disadvantage. Carolyn Brancato estimates that United States institutional investors increased their foreign equity holdings to a total of US \$236 billion in 1993, of which the largest pension funds (those with assets over US \$1 billion) are the major holders, controlling 88.8 percent of all institutional holdings of foreign stocks (Brancato 1993).

In many instances, institutional investors are a more vigorous force for change of the governance of corporations domiciled elsewhere. This was dramatically the case with Harris Associates of Chicago taking the lead late in 1994 in ousting Maurice Saatchi. CalPERS has been prominent in Germany, and Fidelity in the United Kingdom. Apparently the fear of commercial reprisal is less severe outside one's home base. This institutional pressure may predictably have a leveling effect on the governance structures of large companies irrespective of the country of their domicile. Capital costs may be lower in markets where governance standards are highest and information is most transparent. Thus, Daimler Benz reworked its financial statements and changed its governance provisions so as to be able to list its common shares on the New York Stock Exchange. Pension funds, wherever situated, have much in common with other pension funds. As the quintessential long-term investors, they can be a worldwide force for governance reform.

Following the repudiation of socialism, the major industrialized countries are struggling to articulate policies to guide their economic systems. The trend to privatization of formerly government-run or -sponsored entities in the United Kingdom, France, and Italy indicates a move from the traditional centralized "finance capitalism" and toward a more decentralized model. The worldwide pensions systems—public and private—with trustees appointed and elected by different constituencies provide the raw material with which a new diversified structure can be created.

Shareholder activism fits well with a variety of possible successful governance systems. It both can become an indispensable part of a system like that in the United States, which relies on extensive transparency of financial data and hostile takeovers as a final—if drastic—market response to poor management and can also play an important role in other countries, such as Japan or Germany, where the law, tradition, and culture are very different.

### **An Action Program for Pension Plans**

[The pension funds] are not owners because they want to be owners but because they have no choice. They cannot sell. They also cannot become owner-managers. But they are owners nonetheless. As such, they have more than mere

power. They have the responsibility to ensure performance and results in America's largest and most important companies. (Drucker 1991)

Much of the financial history of the 1980s could be written as the rapid but unacknowledged (even by themselves) acquisition of power by pension plans. Because the pension plans did not at first understand the power conferred by their vast ownership, a vacuum was created that was filled by "takeover entrepreneurs." If the pension plans fail to use their power responsibly in the future, a conferral of power on to others will again result. As the volatility of the takeover era showed, this is a significant risk. Pension funds, not only by virtue of their size but also by virtue of their long-term perspective and their fiduciary obligation to a broad section of society (as proxy for the 100 million participants in retirement schemes), are better suited for this role than many, including arbitrageurs, takeover entrepreneurs, and the government.

Only if the pension funds recognize their power and organize to become effective, however, can this work. CalPERS has been a leader since the early days, from establishing the Council of Institutional Investors, to both company-specific and broad-based initiatives, to the lengthy effort to reform the proxy rules. As noted above, the amendment of the proxy rules in 1992 was an enormous step forward, making communication among shareholders much easier. Significant obstacles remain, however. As Fisch (1993) noted, "The extent to which the federal proxy rules frustrate shareholder democracy has been chronicled extensively elsewhere. Many of these issues were brought to the attention of the SEC by the CalPERS letter, but the SEC chose not to address them. In spite of its continued re-examination of the regulatory system and its never-ending series of amendments, the SEC continues to limit shareholder participation in corporate governance both through sins of commission and omission in connection with its proxy rule. Accordingly, the rules remain an unauthorized and misbegotten regulatory endeavor." A beginning agenda of what remains to be done in other federally regulated areas was set forth by Conard (1988: 1198-99). The Council of Institutional Investors has been very effective in pressing for pension plan legislative and administrative reforms.

One of the most pressing is prompt and unequivocal definition of the "exclusive purpose" rule of ERISA (and comparable rules applicable to public pension funds under the laws of most states). The language itself is clear: the pension plan must be administered "solely . . . and for the exclusive benefit of the plan participants." What is unclear is what that means in real-life application. The Department of Labor has been firm in stating that it does not mean the plans should be administered for the employees' benefit as employees or as members of the community, but

for their benefit as pension plan beneficiaries. The only goal is the long-term health and growth of the pension assets.

Among the inevitable compromises in drafting and administering ERISA was the creation of what has been called "the fundamental contradiction of ERISA" (Fischel and Langbein 1988). Plan sponsors were given the right to appoint and control plan trustees. Despite the fact that the legislative history makes it clear that the statute is intended to incorporate the strictest fiduciary standards of the common law, and then add additional strictures to them, from the outset, the position of trustee has been equivocal. Nominally an independent fiduciary, in practice trustees serve the person from whom they are supposed to be independent. We have earlier considered Peter Drucker's twenty-year-old perspective that pension fund management is too important to be a secondary activity of a financial institution. Drucker notes, "But setting up pension fund management as an autonomous institution would only be the first step. It is equally important that pension funds be organized for legitimacy and accountability" (1976:88).

There is no need for the pension funds to wait for governmental action. The pension fund industry generates sufficient fee revenue to support an industry of special-purpose money managers. Pension fund trustees can make a difference by simply insisting on retaining money managers that limit themselves to pension funds as clients. Existing fiduciary banks can rationally elect either to continue their multifaceted relationships or to limit themselves to serving as employee benefit plan fiduciaries—there is a large enough market under either alternative to support their operations. Further, there would be opportunity for new "special purpose" pension-fund-only trust institutions.

Who will start this effort? Once again, the public plans are most likely to lead the way, as they do not run the risk of commercial reprisal in redirecting business. When the public plans have enabled the building of a "pension fiduciary industry" the private plans will find themselves at a competitive disadvantage and may be forced to follow suit. Beneficiary pressures may abet the development of an independent fiduciary system.

Further steps along the lines prescribed by PWBA chief Olena Berg in July 1994 may be necessary. As the Department of Labor notes, it "believes that active monitoring and communication with corporate management is consistent with a fiduciary's obligations under ERISA where the responsible fiduciary concludes that there is a reasonable expectation that such activities by the plan alone, or together with other shareholders, are likely to enhance the value of the plan's investment, after taking into account the costs involved" (USDOL 1994). While PWBA here plainly authorizes the expenditure of funds on appropriate shareholder initiatives, there will need to be precedent, publicity and, ulti-

mately, judicial authority before risk-averse trustees become comfortable risking their beneficiaries' money. In the public plan arena, the problem is politics; state legislatures will not like their pension systems incurring all manner of expenses that have not been legitimated through the appropriations processes. Moreover, the targets of these initiatives are sure to have substantial political clout.

Large fiduciaries are bureaucratic institutions with the same inherent weaknesses as large companies. How can we protect ourselves against simply substituting one bureaucracy for another, increasing costs, and having little or even negative impact on efficiency? Fiduciaries have experience in engaging the services of professional advisors on a competitive basis. To the extent that shareholder activism becomes perceived as simply another potentially value-adding service, providers can be competitively selected and evaluated. The marketplace will be the ultimate judge.

## **Conclusion**

The ancient Greeks believed that, in order for democracy to succeed, citizens had to devote their full time to participation. We now have a shareholder—the pension fund manager—who does devote full time to ownership, the shareholder's equivalent of citizenship. Size makes possible, and fiduciary obligation makes enforceable, the exercise of this citizenship on behalf of those real citizens, the pension beneficiaries. They are the citizens whose interest in the future makes them ideal stewards of America's corporations.

## **Appendix 1: Letter to Exxon Shareholders**

April 3, 1992

Dear Exxon Shareholder:

You have by now received Exxon's proxy statement for the 1992 annual meeting. I wish to call to your attention a shareholder proposal I am making for the establishment of a committee of shareholder representatives. This is the sixth item of business at the meeting and appears at pages 16 to 17 of the proxy statement.

Let me explain what this proposal is all about. I believe a company does better for its shareholders if shareholders get actively involved in seeing that the company is managed well. Companies are managed by their boards of directors, so that positive shareholder involvement means intelligently evaluating what the directors do and interacting constructively with the board. This calls for an active, informed shareholder representative.

In the case of large publicly held companies like Exxon, there usually is not a large shareholder who can fill this role. The largest shareholders of most large

United States companies are institutional investors—mutual funds, insurance companies, public or private employee benefit plans—that hold significant equity stakes in many hundreds of companies. These institutions don't have the resources to play an active, informed shareholder role in their various portfolio companies.

My proposal would establish a three-person committee to take on the role of active, informed shareholder representatives. The three persons would be selected by shareholders, and the cost would be borne by the company—hence proportionately by all shareholders.

How would this work? At each annual meeting shareholders would elect three persons to be members of the committee. Candidates would be nominated by shareholders. Large long-term shareholders, *i.e.*, shareholders (or groups of shareholders) who beneficially own, and have owned continuously for three years, at least US \$10 million in market value of common stock, would have the right to have their nominees included in the company's proxy statement. (Other shareholders could nominate candidates, but I would expect those candidates that are included in the company's proxy statement would have the best chance of being elected.)

Committee members would be paid by the company in an amount equal to half the average amount a nonemployed Exxon director is paid and would be entitled to a reimbursement of expenses and the same indemnification rights as an Exxon director.\* I believe this is necessary in order to attract capable and responsible individuals as committee members.

Sometimes the active, informed shareholder role requires expert assistance—for example, investment banking advice on whether shareholder interests would be served by some type of recapitalization or reorganization. No one shareholder can be expected to spend its own money exploring such issues in depth. The committee would be authorized to engage such expert assistance at the company's expense. I would not expect such expenses normally to be significant in amount. In any event, such expenses in any year would be limited to 1 cent per share outstanding (approximately US \$12.4 million).

The committee's functions would be (1) to review the management of the business and affairs of the company by the board of directors, (2) to advise the board of its views and the views of shareholders which are expressed to the committee, and (3) to report to shareholders (in a report of not more than 2,500 words in the company's proxy statement) its evaluation of the management of the company by the directors and its recommendations on any matters proposed for action by shareholders. I would expect the committee to fulfill these functions by informing itself (hopefully, with the help of company management) on the fundamental strategic issues facing the company, obtaining independent expert assistance (if necessary) in evaluating these issues, and seeking and receiving input from shareholders on these matters.

I do not believe having such a committee need be "cumbersome and expensive." I do not believe such a committee "is likely to interfere with and reduce the efficiency" of the management of Exxon by its board of directors. Nor do I believe such a committee "would duplicate the shareholder communication efforts of the Investor Relations Department" of Exxon.

\*The compensation of nonemployee Exxon directors is set forth on page two of the proxy statement.

I fully understand why a board of directors would be reluctant to endorse a proposal to establish a committee to review and evaluate the board's performance. I believe, however, that shareholders, as owners, would be better off—and shareholder values would be enhanced—if they got actively involved in seeing that their company is managed well. This is a responsibility of share ownership. I believe my proposal to establish a shareholders' committee to take on the role of active, informed shareholder representatives is a positive first step in this process. I urge you to support it.

Sincerely,  
Robert A. G. Monks

Robert A. G. Monks is the president and sole shareholder of Institutional Shareholder Partners, Inc. (ISP), a consulting firm for institutional shareholders, whose office is located at 3333 Water Street, N.W., Suite 220, Washington, DC 20007. Mr. Monks owns 1,325 shares of Exxon common stock. Mr. Monks and ISP are soliciting the execution of Exxon proxies in favor of Mr. Monks' proposal for a committee of shareholder representatives but are not furnishing their own form of proxy for use at the annual meeting of Exxon shareholders. Their interest in the matters set forth herein is solely in connection with their business activities of providing services to institutional shareholders. Mr. Monks will bear the entire cost of the solicitation. Under rules of the Securities and Exchange Commission, this letter may constitute proxy soliciting material, and all the information in the Exxon proxy statement dated March 6, 1992 is incorporated herein by this reference. Mr. Monks and ISP, through its officers, employees and agents, may contact shareholders and others personally, by telephone or in writing, and intend to respond to inquiries, orally or in writing, regarding the matters set forth herein.

## Appendix 2: Exxon Shareholder Proposal

RESOLVED: To adopt the following new by-law:  
Article IIIA

### COMMITTEE OF SHAREHOLDER REPRESENTATIVES

1. The corporation shall have a committee of shareholder representatives consisting of three members. The committee shall review the management of the business and affairs of the corporation by the board of directors and shall advise the board of its views and the views of shareholders which are expressed to the committee. The committee may, at the expense of the corporation, engage expert assistance and incur other expenses in a reasonable amount not to exceed in any fiscal year US \$.01 multiplied by the number of common shares outstanding at the beginning of the year. The committee shall be given the opportunity to have included in the corporation's proxy statement used in its annual election of directors a report of not more than 2,500 words on the committee's activities during the year, its evaluation of the management of the corporation by the directors, and its recommendations on any matters proposed for action by shareholders.

2. The members of the committee shall be elected by the shareholders by plurality vote at their annual meeting. Elections of members shall be conducted in the same manner as elections of directors. Each member shall be paid a fee equal to half the average fee paid to nonemployee directors, shall be reimbursed for reasonable travel and other out-of-pocket expenses incurred in serving as a mem-

ber, and shall be entitled to indemnification and advancement of expenses as would a director.

3. The corporation shall include in its proxy materials used in the election of directors nominations of and nominating statements for members of the committee submitted by any shareholder or group of shareholders (other than a fiduciary appointed by or under authority of the directors) which has owned beneficially, within the meaning of section 13(d) of the Securities Exchange Act of 1934, at least US \$10 million in market value of common stock of the corporation continuously for the three-year period prior to the nomination. Nominations must be received by the corporation not less than ninety nor more than 180 days before the annual meeting of shareholders. The corporation's proxy materials shall include biographical and other information regarding the nominee required to be included for nominees for director and shall also include a nominating statement of not more than 500 words submitted at the time of nomination by the nominating shareholder or group of shareholders.

4. Nothing herein shall restrict the power of the directors to manage the business and affairs of the corporation.

5. This Article IIIA shall not be altered or repealed without approval of shareholders.

#### ACCOMPANYING STATEMENT

The proposed by-law would establish a three-member committee of shareholder representatives which would review and oversee the actions of the board of directors in managing the business and affairs of Exxon. We believe such a committee could be an effective mechanism for shareholders to communicate their views to the board and would serve a useful advisory function at relatively little cost.

#### Notes

1. This is money held and managed by intermediaries—pension funds, insurance companies, mutual funds, endowments, etc.—for the benefit of individuals (investors, pension plan participants, etc.) or non-profit organizations (charities, universities, etc.). All statistical material is provided from Brancato (1995), unless a different edition is indicated.

2. During the first quarter of 1995, the Public Employee Retirement System of California indicated an increase in its targeted percentage of equity investment to 63 percent.

3. In the 1986 Federal Employee Retirement System Act, Congress provided that federal employees may elect to invest in an equity index but not in individual companies.

4. "Soft dollars" are a sort of frequent flyer miles for stock transactions and are an off-budget resource that can be used to pay for research (rather broadly defined).

5. We have found a very significant difference at those companies that give their shareholders the protection of confidential voting. At companies that insist on knowing how their shareholders voted (and that often use this knowledge to push anyone voting against management to change their votes), it is far more difficult to get a strong showing of support for shareholder initiatives than at companies that guarantee that all votes are confidential.

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