

Put Your Mouth Where Your Money Is

Funds and insurers own half the stock in listed U.S. companies. Their voice in corporate governance should be louder

Last year brought the most sweeping regulatory changes in corporate governance since the 1930s. A big question for 2003 is whether the momentum will continue or fade. The answer will partly depend on whether investors--especially big institutional investors--keep pressing for change.

The argument for more shareholder democracy is well known: Capitalism works best when owners look after their own interests, which are often not the same as those of corporate management. Boards of directors are supposed to represent shareholders, but they are selected not by shareholders but by management. Practically speaking, however, the country's 80 million retail investors are too dispersed and not knowledgeable enough to wield clout over Corporate America. This is not the case for pension funds, mutual funds, and insurance companies, since they collectively account for more than 50% of all U.S. registered shares outstanding and have major research capabilities.

So what should these institutional investors do? In speeches and articles, corporate governance expert Robert Monks has advocated that they should nominate at least three independent directors for each major publicly listed company; that all independent directors have access to outside advice on all significant mergers-and-acquisitions activity of their companies; and that they have complete control over audit and remuneration committees.

California Treasurer Philip Angelides, who oversees the state's public pension funds, wants institutional investors to target a few issues that will shake America's boardrooms. He wants funds to withdraw business from banks that persist in conflicts of interest between researchers and underwriters. He'd like institutional investors to publicly shame companies with egregious compensation policies. "The time has passed for writing letters and dropping by for quiet conversations with management," he told me.

I asked Patrick McGurn, vice-president and general counsel of Institutional Shareholder Services, about targets for stepped-up institutional activism. He

talked of a possible shift from procedural issues--which Congress, the Securities & Exchange Commission, and the stock exchanges have dealt with--to more qualitative questions. Shareholders could well focus not just on the independence of auditing firms but also on the the mandatory rotation of them, he said. They could pass judgment on how well directors have tied executive pay to performance. They could examine the depth of CEO succession planning. They could press for strong lead directors.

There are many skeptics. Robert Pozen, recently retired vice-chairman of Fidelity Investments, told me that while institutions ought to act diligently-- by keeping an eye on compensation, takeover proposals, and other issues that directly affect the price of securities--they are unlikely to do much more. The reason: They can't see the connection to their primary mission-- generating higher financial returns.

In another interview, Alistar Ross Goobey, who chairs the International Corporate Governance Network, explained to me that many institutions worry about getting too involved in governance issues for fear of offending the corporations on whose business they depend. He adds that many institutions churn their portfolios so often that they are part of the problem-- the short-term focus of U.S. companies. As Sarah Teslik, executive director of the Council on Institutional Investors, told me: "Any stepped-up activity by institutions will be gradual, not dramatic."

Last week, a commission formed by the Conference Board recommended that institutional shareholders dramatically increase their oversight of companies in which they have invested. But exactly where on the spectrum of activism institutional investors will emerge may depend on the Bush Administration. I'd like to see the SEC mandate easier and less-costly procedures for institutional shareholders to get their resolutions on ballots. It should force more activism by making it mandatory for institutional investors to vote their proxies and disclose how they voted. It should direct fund managers to set as their highest priority good long-term financial results for their beneficiaries, and then call for more public assessment of their performance in that context. It should jawbone top executives of institutional investors to get their organizations more involved in monitoring governance. Ultimately, these actions could even lighten the monitoring and enforcement burden on an already overstretched SEC by transferring more responsibility where it belongs--to the private sector.

With surveys showing that over 40% of investors think the securities industry is dishonest, the Bush Administration must be the champion of the small investor. But it's only the big guys who will force needed changes. "This will be a watershed year for institutional investors," says California's Angelides. "We'll see if they can mobilize for lasting impact." Let's hope they do.

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