

John C. Bogle

Democracy in corporate America

“If men were angels, no government would be necessary.” James Madison’s perceptive warning in *The Federalist*, No. 51, provides an appropriate place to begin a discussion of the role of shareholder democracy in the governance of America’s giant publicly held corporations.

Paraphrasing the great Madison’s words, “If chief executives were angels, no corporate governance would be necessary.” Yet if anything is clear about corporate governance during the recent era, it is that chief executives, like the rest of us, are not angels. I am referring not only to the headliners – convicted felons such as Enron’s Ken Lay and Jeffrey Skilling, WorldCom’s Bernard Ebbers, Tyco’s Dennis Kozlowski, and Adelpia’s John Rigas – but to a far larger cohort of chief executives who stretched generally accepted account-

ing principles to their very limit, and even beyond, in order to create *accounting* earnings that measured up to the guidance they had provided the professional security analysts of powerful Wall Street investment banking firms (the ‘sell side,’ promoting stocks to money managers) and the giant institutional investing firms (the ‘buy side,’ purchasing those stocks).

This accounting gimmickry was too often performed right under the knowing eye of public accounting firms. These firms compromised their independence by providing management-consulting services to the very companies whose financial statements they were providing attestation. In the aftermath of the 1998 – 2000 stock market bubble, many companies were required to restate the audited earnings figures they had reported. There have been some 6,441 restatements of earnings by publicly owned companies since 2001. These restatements have come not only from companies of marginal standing in the business community but also from some of the largest and most highly regarded corporations in the United States, including General Motors, General Electric, Fannie Mae, Xerox, Bristol-Meyers Squibb, Citigroup, and Marsh & McLennan.

Restating earnings is not a crime. But it is a symptom of the ‘financial engi-

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neering' methodology of our corporate managers. What is more, other ways of artificially enhancing earnings do not even require restatement. It is, for example, in no way inconsistent with accepted accounting standards for a corporation to raise the assumed future return of its pension plan with nothing more than a guess, usually fortified by a statement that its financial officers and actuaries have said grace over the increase. Such a change can easily convert a company's annual loss into a stunning profit. In 2001, Verizon Communications incurred a loss of some \$1.4 billion on its operations. However, when it increased the assumed future return of its pension plan from 9.0 percent to 9.25 percent, it created \$1.8 billion of phantom income, resulting in a reported net income of nearly \$400 million,¹ and enabling the firm to pay executive bonuses that would otherwise have been eliminated.

Verizon was hardly atypical in this action. In 1981, the assumed returns for the pension plan of the typical U.S. corporation were 6.0 percent. But by 2000, the assumed returns had risen to 9.0 percent, even though the outlook for prospective returns for stocks and bonds had sharply deteriorated. (For example, the yield of the benchmark ten-year Treasury note – a highly accurate indicator of the note's return over the subsequent decade – was 13.9 percent at the start of the period, but only 5 percent at the end.)

But even with all that financial engineering, from 1980 through 2004 corporate earnings had grown, not at the annual rate of 11.5 percent that our corporate leaders had projected (over five-year increments) but at a rate of just 6 percent. That rate of growth failed to

¹ Ironically, this pension income was recorded in a year in which the actual value of the pension plan dropped by \$3.1 billion.

match even the 6.2 percent growth rate of the American economy during the same period. So while stock prices soared by almost 800 percent during this era, roughly 500 percentage points of that total were the result not of corporate accomplishment but of an increase in the valuation of stocks, with prices on balance soaring from nine to twenty-one times earnings.

Reflecting, then, not extraordinary business achievement but an upward revaluation of stocks of a once-in-a-lifetime dimension, the compensation of the average CEO rose from \$625,000 to \$9,840,000, a 12.2 percent annual rate of increase. This rate is double the earnings growth rate achieved by the firms themselves, which, as I pointed out, was below the growth rate of the economy at large – a fact that is surely more indicative of the failure of our CEOs in the aggregate than of their success.

Of course, the compensation of the average worker also grew – more than doubling from \$14,900 to \$35,100 – but at a rate of only 3.6 percent per year, less than one-third of the pace of the CEO's increase. When we translate these figures into *real* dollars, reflecting their 1980 spending power, the gap is far more striking. CEO pay rose more than sevenfold to \$4,500,000 in real terms, while the real annual pay of the average worker rose from \$14,900 to \$15,900, only 0.3 percent per year.

Through the contrast in these increases, the CEO implicitly sends this message: "I am the powerful emperor who created the entire increase in the value of the corporation. All of you, our dedicated and loyal employees, contributed virtually nothing."² One can only recall

² As someone who has served as chief executive of two major companies for a total of thirty years, I simply cannot imagine such an absurd conclusion, one totally contrary to the way that business actually works.

the dictum of King Louis XIV: “*L’ état c’est moi.*”

These excesses in executive compensation, and the directly related machinations of financial statements, reflected the erosion in the conduct and values of our business leaders during the recent era, when something went wrong with American capitalism. The system – which had served us well for so long – changed, one more aberration in the long course of capitalism. While each of its earlier failures was followed by safeguards put in place as defenses against future abuses, none of them contemplated the next sort of scandal that, perhaps almost inevitably, would follow.

The central ethic of the system of modern capitalism when it began in Great Britain around the start of the eighteenth century – trusting and being trusted – was gradually eroded. What went wrong this time, as the journalist William Pfaff described it, was “a pathological mutation in capitalism.” The classic system – *owners’* capitalism – had been based on a dedication to serving the interests of the corporation’s owners by maximizing the return on their capital investment. But a new system developed – *managers’* capitalism – in which, Pfaff wrote, “the corporation came to be run to profit its managers, in complicity if not conspiracy with accountants and the managers of other corporations.” Why did it happen? “Because the markets had so diffused corporate ownership that *no responsible owner exists*. This is morally unacceptable, but also a corruption of capitalism itself.”

Much of the responsibility for this change can be found in the ascent of the imperial chief executive officer as the new paradigm of management. Self-interest came to the fore, and the stewardship of stockholder property took a back

seat. A 2002 Harvard University/Wharton School paper on “Corporate Governance and Equity Prices” characterized this change by contrasting corporate *dictatorships* with corporate *democracies*:

Corporations are republics. The ultimate authority rests with the voters (shareholders). These voters elect representatives (directors) who delegate most decisions to bureaucrats (managers) One extreme tilts toward democracy, reserves little power for management, and allows shareholders to quickly and easily replace directors. The other extreme tilts toward dictatorship, reserves extensive power for management, and places strong restrictions on shareholders’ ability to replace directors.³

While those are strong words, they capture the essence of the problem. Indeed, when speaking in 2003 to the CEOs of America’s largest corporations at their Business Roundtable, I suggested that we needed more democracy among our firms and less dictatorship. My remarks were not particularly well received, and I was reminded that the job of the CEO was tough enough without the interference of owners in the company’s governance and operations.

Few of us would expect our corporate CEOs to be angels, but it should be clear – based on the evidence of gross executive overcompensation and financial engineering – that we need better governance of our large publicly held corporations. The reality is that our modern-day corporations fail to follow a primary principle of good governance laid down by the founding fathers of our republic:

3 Paul A. Gompers, Joy L. Ishii, and Andrew Metrick, “Corporate Governance and Equity Prices,” *Quarterly Journal of Economics* 118 (1) (February 2003).

the *separation of powers*, an idea that, as our knowledgeable forebears were well aware, goes back to Montesquieu and John Locke and, indeed, to ancient Greece and Rome. In *The Federalist*, No. 51, Madison explains this doctrine:

In a single republic, all power surrendered by the people, is submitted to the administration of a single government; and usurpations are guarded against by a division of the government into distinct and separate departments ... (which) will control each other; and at the same time that each will be controlled by itself ... a dependence on the people is no doubt the primary control of the government; but experience has taught mankind the necessity of auxiliary precautions ... (a policy that) might be traced through the whole system of human affairs, *public* as well as *private*. (Italics added.)

In corporate America, the 'government' consists of the directors, the management, and the so-called gatekeepers of our corporate system – the independent public accountants, the federal and state regulatory authorities, and the framework of corporate law established by our national and state governments. As in our republic, quoting Madison in *The Federalist*, No. 39,

the government (i.e., the corporation's board of directors) derives power directly or indirectly from the great body of the people (i.e., the corporation's shareholders), and is administered by persons holding their offices during pleasure, for a limited period, or during good behavior. It is *essential* to such a government that it be derived by the great body of the society, not from an inconsiderable proportion or favored class of it, otherwise a handful of tyrannical nobles, exercising their oppressions by a delegation of their powers, might aspire to (its control).

In the recent era, however, America's corporations have departed sharply from this timeless principle of sound governance. The chief executive now reigns almost unchecked over the other two branches of corporate America. Chief executive officers hold dominion over boards of directors, who seem more loyal to the chief executive officers whom they have chosen – or by whom they themselves have been chosen – than to the shareholders who are, in fact, the owners of the corporation.

The gatekeeper system (the judicial branch of corporate government) has also faltered, at each level: public accountants, for one, are no longer independent appraisers of management's financial statements, but, through lucrative consulting relationships, have become partners of management, sometimes even providing aggressive tax-shelter schemes to the very executives of the companies whose books they audit.

Another mainstay of the corporate judicial branch has also stumbled. Basic investor protections provided by the Glass-Steagall Act and the Securities Acts – enacted to deal with the failures that contributed to the 1929 – 1933 market crash – were relaxed, sharply vitiating long-standing safeguards. And Congress, lobbied vigorously, has too often surrendered to corporate interests. The most notable example came in 1993, when the U.S. Senate forced the Financial Accounting Standards Board to withdraw its proposal requiring that compensation paid to corporate executives in the form of stock-option awards be treated as a corporate expense, just like all other forms of executive compensation. Allowing stock options to be treated as 'free' – i.e., not charged against earnings – has played a major role in the gross excesses in CEO compensation.

But it is our corporate directors (the legislative branch) who must bear the onus for the failures of corporate America. Under the established laws of our corporations, it is the directors who are “entrusted with the *responsibility for the management* of the corporation.” Just as legislators are subject to the will of the voters, so the members of a board of directors should ultimately obey the will of the shareholders. Directors are the stewards who have the responsibility of overseeing the preservation and long-term growth of the corporation’s assets for the benefit of its owners.

Until recently, shareholders trusted directors to act properly without interference. We relied on directors to do their duty. Nowadays, too many directors fail to consider that their overriding responsibility is to represent not the management but those largely faceless, voiceless shareholders who elected them. They no longer honor the director’s golden rule, in the words of Warren Buffett: “Behave as if the corporation you serve had a single absentee owner, and do your best to further his long-term interests in all proper ways.”

It is the director, then, who has the responsibility of checking the behavior of managers who are seduced by the siren song of unfathomable riches, largely unfettered by the notion of serving the interests of the corporation’s long-term owners, and easily tempted to focus on driving the stock price higher. Often these goals are unrealistically high, especially since the investment community brooks no interruptions in a regular progression of earnings growth. The temptation to run the business around the numbers becomes overwhelming. To meet the numbers, important long-term initiatives are usually the first to be cut; downsizing (artfully renamed ‘rightsizing’) is next in line; financial standards

are then pushed to the limit; and finally, earnings become so illusory and subjective that credibility is lost. What can all too easily follow is severe damage to the corporation’s reputation and then its business, happening right under the noses of our corporate directors and traditional gatekeepers.

Directors and gatekeepers have failed to protect owners against managements that are all too eager to cast their firm’s lot in terms of numbers rather than intrinsic values, corporate character, and meaningful self-appraisal. Even otherwise sound companies dwell too heavily on what can be easily measured – market share, productivity, efficiency, product quality, costs – and set internal goals to achieve them. Business is fiercely competitive, and when achieving these self-imposed measures proves impossible, it is only a matter of time until the measurements themselves are distorted and forced. When *measures* become *objectives*, they are often counterproductive and self-defeating – at times producing the very results that companies wish to avoid. The role of management should not be to beat abstract numeric estimates but to improve the operations and long-term prospects of organizations by providing forceful and lucid direction, and to do so by both exemplifying and demanding a moral and ethical framework for behavior.

There are two very different measures of accomplishment in modern capitalism: creating shareholder value by raising the intrinsic value of the corporation, and creating shareholder value by raising the price of the stock. Roger Martin, at the University of Toronto, contrasts the *real* market of business *firms* – “Real companies spend real money to buy and sell real products and earn real profits; (and) strategy requires skill, will, and experience” – with the *expecta-*

tions market of stock investors. John Maynard Keynes called the former *enterprise* and the latter *speculation*. I describe the difference as the contrast between the eternal *reality* of intrinsic value and the momentary *illusion* of stock prices. Whatever the terms, in the recent era, unsurprisingly to anyone who has actually managed a business, it has proven far easier to raise the valuation of the stock than to increase the intrinsic value of the corporation. Yet, as Buffett warns, “over time the aggregate gains made by shareholders must of necessity match the business gains of the corporation.”

In a properly functioning representative democracy, one would expect the ire of the citizens to be aroused when the executive, the legislature, or the judiciary ignores their interests. But even when all three branches did so – when managements put their own interests first, and the directors and gatekeepers failed to challenge them – the citizen/owner of corporate America simply stood by, seemingly without concern, creating a power vacuum. Spinoza warned, “Nature abhors a vacuum,” and our CEOs quickly filled it. They were able to do so largely because of the radical changes in both the structure and character of ownership during the last half of the twentieth century.

In 1950, stocks were overwhelmingly held directly by individual owners. Some 92 percent of shares were held by these owners, with only 8 percent held by financial institutions, such as pension plans and mutual funds. By the 1990s, however, the balance had tilted toward institutional owners – 53 percent versus 47 percent for individuals. And by 2006, institutional ownership of U.S. corporations had reached an all-time high, estimated at 68 percent, with individual shares falling to 32 percent.

These institutions – largely the managers of mutual funds (now owning 28 percent of all stocks); private pension funds (15 percent); and federal, state, and local pension funds (9 percent) – are not direct owners of the stocks in their portfolios. Rather, they are *agents*, responsible for representing the interests of their principals. This new *agency* society has replaced the *ownership* society of yore. But with too few exceptions, the agents have placed their own interests ahead of those of their principals, especially mutual-fund shareholders and pension-plan beneficiaries.

The reasons for this change are manifold. With only a single exception, mutual-fund managers are themselves corporations, in business first and foremost to earn the maximum possible return on *their own capital*. And when the costs of financial intermediation – agency costs – represent, as they do, an absolutely certain dollar-for-dollar diminution in the returns earned in the financial markets themselves, the tautology is obvious: investors as a group not only don’t get what they pay for, they get precisely what they don’t pay for. One might add, accurately (if a bit cynically), if they pay nothing, they get everything (i.e., without intermediation costs, equity investors would capture the entire return of the stock market). As the mutual-fund industry rose to its present-day preeminence as America’s largest stockholder, it focused far more on marketing and asset gathering and on the profitability of its own manager/agents than on assuming the responsibilities of corporate citizenship for its shareholder principals.

Different agency problems arose in the pension-fund field. The unrealistic increase in the assumed future returns of pension funds – which had such a salutary, if illusory, short-term effect on corporate earnings – enabled the very man-

agements responsible for making those projections to reap giant profits by exercising their stock options at the earliest possible opportunity. Yet when the reality of actual financial-market returns ultimately came home to roost, falling far short of those rose-colored guesses, pension-plan assets fell hundreds of billions of dollars below their liabilities to retirees. (Informed estimates place the current deficit at \$1.2 trillion.)

Institutional money managers are, of course, closely linked to the corporations that are funding retirement plans for their own employees. That is, they are agents of agents. It doesn't take a lot of imagination to realize that corporations themselves are unlikely candidates to be governance activists and aggressively vote the shares their pension plans hold in other corporations. Private pension plans, the evidence shows, are the most passive of all shareholders. Moreover, with corporations as their largest clients, institutional managers of pension plans and 401(k) thrift savings plans have little enthusiasm for offering, or voting in favor of, proxy resolutions opposed by the managements that employ them. As it has been observed, there are two classes of clients that institutional investors prefer not to offend: *actual* clients and *potential* clients.

To a large extent, therefore, the *owners* are now the *owned*. Corporate defined-benefit pension plans own 8 percent of all stocks, and corporate defined-contribution thrift plans own another 7 percent – together almost one-sixth of shares outstanding. Adding the estimated 25 percent of stocks held for clients by brokerage firms – themselves mostly units of giant publicly held financial corporations – brings the total ownership of all shares held by corporations and their natural allies to some 40 percent. Small wonder that one can never be sure who

is paying the piper and calling the corporate-governance tune, and with what motivation.

Even as the character of corporate ownership changed, so did the nature of stock ownership. In terms of enlightened corporate governance, it was another change for the worse. The strategic ethos of investment America moved from the wisdom of long-term investing to the folly of short-term speculation. As otherwise intelligent institutional investors came to focus on stock prices rather than on corporate values, *stockowners* were transmogrified into *stockholders*. Those who *rent* stocks hardly need care about the responsibilities of corporate citizenship, but those who *own* stocks *must* care about governance.

How money managers behave cannot be divorced from how corporate managers behave (and vice versa). If the money manager concentrates almost exclusively on the price of the stock rather than on the intrinsic value of the corporation, we should not be surprised when the corporate manager, in an attempt to 'game' the system, also focuses on the stock price. By the same token, when the corporate manager plays games with earnings, we should not be surprised when money managers endeavor to capitalize on the market's callow acceptance of whatever earnings the corporation reports, accepting uncritically the illusory along with the real.

Our professional analysts easily signed on to this illusion, measuring up to Oscar Wilde's definition of the cynic: "One who knows the price of everything and the value of nothing." And when our stockowners – especially our giant institutions – focus so heavily on short-term investment horizons, responsible corporate citizenship is among the first victims. While corporate-governance issues

demand vital concern on the part of the long-term investor, they are hardly likely to trouble the short-term speculator.

Far too large a portion of the investment-management industry may be fairly characterized as having a bad case of short-termism. The temperature of the investment patient, as it were, can be measured by his portfolio turnover rate. For decades, up to and including the mid-1960s, the average annual turnover of stocks in equity mutual-fund portfolios, for example, remained at a remarkably stable annual rate of roughly 15 percent per year. But it steadily ascended, reaching around 100 percent during the 1990s, where it remains today. With the fever soaring to such heights, it is small wonder that the patient's interest in governance faded accordingly.

The consequences of these changes in the structure and character of ownership during the past half-century have been reflected in the virtual absence of mutual funds and private pension funds from actual participation in corporate governance:

- No mutual-fund firm or private-pension manager has ever sponsored a proxy resolution that was opposed by management.
- Not a single institutional manager testified before Congress regarding the expensing of executive stock options.
- No institutional investor testified before Congress about the most significant piece of legislation affecting public companies in the last seventy years, the Sarbanes-Oxley reform bill.
- Among the some seventeen thousand responses to the Securities and Exchange Commission (SEC) proposal to grant institutions limited access to proxies in order to nominate corporate directors, no large shareholder de-

manded more substantial access, and most didn't even bother to comment. (A few even argued for more stringent limitations on access.)

- No large shareholder has urged the Financial Accounting Standards Board to require stock options to be expensed.
- The only mutual-fund company that commented on the 2005 SEC proposal for greater disclosure of executive compensation was a fund group organized by a labor union.

Far too many corporate executives and directors have been placed in positions of great power and authority without an adequate understanding of their fiduciary duties. At the same time, far too many institutional agents have failed to insist that these officials serve the interests of the last-line investors they represent. All we have heard from these owners is the sound of silence. If the owners don't give a damn about the triumph of managers' capitalism, it is fair to ask, who on earth should?

It's time that stockholders demand that directors and managers alike honor the primacy of their interests. The corporation, after all, is their property. If the elected directors of the republics that govern corporate America are not responsive to the interests of their constituency – even worse, if dictatorships come to hold sway – then the voters ought to have the power to throw the rascals out.

It's not very complicated: *owners should be allowed to behave as owners*. If ownership rights are not placed front and center, where should they be placed? Who would dare to suggest that barriers be placed in the way of the right of shareholders to elect directors who serve as their agents? Or to compel management to operate in their interest? Or to assume responsibility for how the execu-

tives of their company are compensated? Aren't these among the basic rights of ownership?

Clearly, these are among the rights of the 100 percent owner, who brooks no interference with his will. And any manager who flatly refused to consider the views of a 50 percent owner, or even a 20 percent owner, would soon be looking for another line of work. But what happens when owners are dispersed across a dozen institutions, each holding a 3 percent interest and sharing a particular viewpoint or wishing to nominate a director? When we move from democracy to something else, just when does the proverbial shovel break? And does the argument that it *might* break when no single owner holds more than, say, one-tenth of 1 percent of the corporation's shares justify rejecting the idea of *any* democracy in corporate governance? Not for me it doesn't. For I believe, paraphrasing Churchill, that corporate democracy is the worst form of government except for all those others that have been tried from time to time.

The idea of a democratic agenda for most corporations has, not surprisingly, met with little favor in the corporate community. Leading securities attorney Martin Lipton argues that enhancing shareholders' ownership rights to nominate directors and to make proxy proposals could "disrupt the proper functioning of the board and limit the ability of the directors to fulfill their fiduciary duties." Henry G. Manne, dean emeritus of the George Mason University School of Law, contends that "the theory of corporate democracy... has long been a standing joke among sophisticated finance economists." (He names no names.) He continues:

A corporation is not a small republic...
and the board is not a legislature... a vote

attached to a share is totally different from a political vote... the essence of individual shareholder participation is 'exit,' not 'voice'... and they can exit their corporate 'citizenship' for the cost of a stockbroker's commission.⁴

In other words, if a shareholder doesn't like the way a company is being run, he should sell to the first bidder. Whether or not the price reflects the corporation's intrinsic value, and regardless of the financial sacrifice involved, the investor should just get out and stay out. 'Like it or dump it,' however, hardly seems a particularly enlightened basis for public policy.

Fulfilling the promise of responsible corporate citizenship does not require a radical change in the existing institutional *structure*. What we need to change are the policy constraints that unreasonably limit stockholder rights. We must address two principal issues, each of which pertains to shareholder access to the company's proxy statement: one, the ability of owners to elect or reject management's board nominees and to nominate other candidates for board membership; and two, the ability of shareholders to place governance and other appropriate proposals in the proxy that, if approved, require compliance by management.

Delaware law has reaffirmed, again and again, the ability of owners to mount electoral challenges to independent directors. As the state's Chancery Court noted in its 1985 *Unocal* decision, "If the stockholders are displeased with the action of their elected representatives, the powers of corporate democracy are at their disposal to turn the board

⁴ Henry G. Manne, "Citizen Donaldson," *Wall Street Journal*, August 7, 2003.

out.” In *Blasius Industries*, in 1988, chancellor William T. Allen added, “The shareholder franchise⁵ is the ideological underpinning upon which the legitimacy of directorial power rests.”

Yet, in the proxy process, owners often fail to exercise their franchise. Even when there is a theoretically independent nominating committee, the CEO is apt to control the slate. And since the costs of opposing proxy recommendations are high and the odds of success low, challenges to management-nominated directors have been rare, and successful challenges almost nonexistent.

Still, it’s up to the owners, and not the managers, to weigh the pros and cons of the issues surrounding electoral challenges and board composition, and, by exercising their franchise, decide them. If owners had the power to select directors, subject only to reasonable constraints, then the board would be far more responsive to their interests. Since treating owners as second-class citizens and insulating the board from serious challenge clearly played a major role in the triumph of managers’ capitalism over owners’ capitalism, today’s status quo is no longer acceptable.

Stockholders must also have the ability to make proposals regarding certain corporate activities. In an earlier era, the SEC allowed management to exclude the overwhelming majority of such shareholder proposals from the proxy on the grounds that they were related to the “ordinary business” of the corporation. In recent years, however, the SEC has permitted a variety of proposals to be

included in proxies, including some designed to limit executive compensation. It would not be unreasonable for the owners to insist that compensation to senior management be directly related to real achievements in building long-term corporate value.

What is more, when a proxy proposal is made and an overwhelmingly favorable vote obtained, companies can, and often do, ignore it. Under the laws of most states, shareholder votes are non-binding, or in legal terms ‘precatory.’ We need changes in state law that require management to honor shareholder decisions. The whole underpinning of our capitalistic system depends upon the notion that the will of shareholders shall be done.

The entrenched business interests allege that even limited access to the slate would open the door to ‘special interest’ or less-qualified directors and dysfunctional boards, and to proposals by shareholders focused on their own vested interests, such as labor unions, state pension funds, and religious orders. But we have no reason to assume that a majority of owners would vote for unqualified directors or irresponsible proxy proposals. *Importantly, these adverse developments could not occur without the consent of a majority of the shares held by the owners themselves.*

If state laws prove inflexible, we ought to consider federal chartering of corporations – something that was debated at the Constitutional Convention in 1787. James Madison argued that the new federal government should be authorized to charter corporations. But as journalist Roger Lowenstein points out,

Federal charters smacked of royal perquisites, [so] it was left to the states to write the rules. Delaware, through its utter permissiveness, became the corporate

⁵ The choice of the word ‘franchise’ seems inspired, since its definition relates both to the political sector and the corporate sector: “The full membership of a body politic or corporate. Citizenship.” *The Oxford English Dictionary*, 2nd ed.

residence of choice, much as the Cayman Islands is a paper domicile for secrecy-minded bankers. To this day, more than half of America's largest companies are incorporated in its second-smallest state. Delaware laws are so lax they don't even require publishing an annual report.⁶

Even when stockholders gain the rights of access to which simple common sense suggests they are entitled, we need to demand that the financial intermediaries that dominate investment America put the interests of those they serve as their first priority. We must strengthen the traditional fiduciary law, now only loosely administered by the states in which corporations are chartered, by perhaps considering a strong federal statute establishing standards of fiduciary duty for pension trustees and mutual-fund directors, indeed all agents responsible for handling other people's money.

At the same time, last-line stockowners must demand high standards of trusteeship from those who are supposed to represent their ownership interests. In mutual funds, those 95 million direct owners have no individual power but awesome collective power. Fund investors need to understand what investing and trusteeship are all about, and, by voting with their feet, gradually gravitate to fund organizations that are serious about putting their interests first.

While the contributors to thrift plans and the beneficiaries of pension plans presently have no similar mechanism, they surely deserve some formal legal voice in establishing standards of conduct for the trustees of the assets that have been set aside to fund their retirements. The law is clear that retirement-

plan fiduciaries have duties of loyalty and prudence, but we need further articulation of exactly what those words mean, and the standards by which we will measure their achievement.

If only our institutional investors summon the courage to exercise the voting franchise they hold, they have the power to begin to force constructive change. Investors already can and should:

- Withhold votes for board chairmen who are also CEOs, demanding the separation of powers between the 'boss of the business' (management) and the 'boss of the board' (governance).
- Vote against auditors who are also providing consulting services (or receiving consulting fees that are disproportionate to their audit fees).
- Withhold votes for board members who serve on audit committees, compensation committees, and governance committees when their qualifications or their independence seem doubtful.
- Vote for proposals that demand open governance (for example, the elimination of staggered boards).
- Vote against proposals that excessively protect companies from takeovers, such as poison pills. (Provisions that are designed to enable companies to negotiate a higher price in the face of hostile takeover attempts are quite another matter.)
- Vote against excessively generous and lottery-type stock-option plans.
- Demand that no director can be elected except by receiving a majority vote of shares. (Of all of these ideas, this one is currently gaining the most traction.)

Full access to the proxy statement, however, should not be unlimited. Why

⁶ Roger Lowenstein, "A Boss for the Boss," *New York Times Magazine*, December 14, 2003.

should short-term *renters* of stocks have the same privileges as long-term *owners*? We ought to consider, for example, limiting director nominations to investors who have collectively owned, say, 5 to 15 percent of shares for at least two years, although all holders would presumably be empowered to cast their ballots.⁷

Real change will come, then, not in the form of continual confrontation with corporate managers and boards of directors, but in the form of the omnipresent reminder that a constituency of owners exists and that it has a strong voice. Faced with the latent power of investment America, the legislature of corporate America – the elected members of the nation’s boards of directors – will again honor their traditional role as stewards of the shareholders’ assets. Corporate democracy will yield republican governance.

But even after systemwide reforms are put into place, the need to create an ownership ethic will remain. When it described the ideal owner as a long-term stockholder, perhaps even a permanent owner, whose goals are closely aligned with the corporation, *The Economist* got it right:

Everything now depends on financial institutions pressing even harder for reforms to make boards of directors behave more like overseers, and less like the chief executive’s collection of puppets Financial institutions must also fight to restore their rights as shareholders and use their clout to elect directors, who would be obliged to represent only their collective interest as owners. Chief executives would still run their firms; but, like

any other employee, they would also have a boss.⁸

The giant institutions of investment America must take the lead in accomplishing these goals. Our money managers not only hold 68 percent of all shares, but they have the staff to pore over corporate financial statements and proxies; the professional expertise to evaluate CEO performance, pay, and perquisites; and, once full disclosure of all proxy votes (by pension funds as well as mutual funds) becomes mandatory, the incentive to vote in the manner that their beneficiaries have every right to expect. When they return – as they must – to their traditional focus on long-term investing, these institutional owners must fight for the access to the levers of control over the corporations they own that are both appropriate for their ownership position and a reflection of their willingness to accept both the rights and responsibilities of corporate citizenship.

The task of returning capitalism to its owners will take time. But the reality is that proper corporate governance is not merely an ideal to be debated; it is a vital necessity to be practiced. The role of owners is to ensure that the interests of directors and management align with their own in a substantive way. When there is a conflict of interest, it should be resolved in the interests of the shareholders. It is in the interest of the public and of investors that owners come to recognize that enlightened corporate governance is not merely a right of business ownership. It is a responsibility to the nation, and we can bring it about only through some improved form of corporate democracy.

7 The obvious long-term owners, of course, are stock-market index funds, which by definition follow a buy-and-hold policy. Today, index funds own an estimated 20 percent of all shares of U.S. corporations.

8 “Getting Rid of the Boss,” *The Economist*, February 6, 1993.