

3-21-2003

## Common Sense and Civic Virtue: Institutional Investors, Responsible Ownership, and the Democratic Ideal

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### Recommended Citation

Murningham, Marcy (2003) "Common Sense and Civic Virtue: Institutional Investors, Responsible Ownership, and the Democratic Ideal," *New England Journal of Public Policy*. Vol. 18: Iss. 2, Article 8. Available at: <https://scholarworks.umb.edu/nejpp/vol18/iss2/8>

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# Common Sense and Civic Virtue

# Institutional Investors, Responsible Ownership, and the Democratic Ideal

*Marcy Murningham*

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*On matters of governance, the people's good is the highest law, as Cicero said two millennia ago. Unfortunately, these days personal greed has trumped the people's good, enflaming the current governance crisis affecting our public, nonprofit, and private spheres. The spate of corporate governance scandals over the past several years jeopardizes equity investments, harms beneficiaries, and weakens global capital markets. The remedy is not just more laws and regulation but revitalization of the system of corporate checks and balances that already exists. To get better corporate governance, corporate shareowners, especially institutional investors, need to assert their rights and responsibilities more forcefully and wisely. Doing this involves better fiduciary leadership and governance, with the establishment of a fiduciary creed. This creed sets forth ethical stewardship beliefs, principles, and standards, thus enabling sound procedures and competence for discharging the fiduciary role. It does so in a manner that serves beneficiaries by balancing long-term financial prosperity with institutional mission and the public interest, rightly understood. Improving the governance and operation of institutional investors through better integration of their ideals and principles into their investment policies, along with greater levels of participation, representation, and accountability — exemplified by The Boston Foundation and recently proposed legislation affecting the \$28 billion Massachusetts state pension funds — will put wasted assets to work, deter future abuse, and restore integrity and trust in equity culture. The author calls this “civic stewardship.”*

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Common sense is not so common.

—Voltaire, 1764

The ultimate fiduciary failure with respect to the Enron collapse was shareholder inactivity. Shareholders were responsible for the board. In the United States today, voting control of virtually all publicly traded companies rests in trustees, the scope of whose responsibilities can be defined under existing federal law.

—Robert A.G. Monks, 2003

“**T**his too shall pass” was my late mother’s mantra, a Buddhist phrase that always provided comfort while facing forces beyond our control. No slouch she, though: as a politician’s wife (Dad was mayor of Lansing, Michigan, in the 60s) and civic leader in her own right, Mom taught all of us that with tragedy or

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loss, you could mourn while still working to make things better. Letting things “pass” did not mean being “passive,” and if you tried to do the right thing while minding your manners, your politics, and your reputation, things eventually would get better.

This advice could be applied to current events, as we confront a crisis of governance and an assault on the democratic ideal affecting our public, nonprofit, and private spheres. In electoral politics, our belief in representative democracy was challenged by the uncertainty and turbulence over the results of the 2000 U.S. Presidential campaign, with a Supreme Court overriding American voters too many of whom stayed home on Election Day. Declining voter participation, the predominance of special interests and Big Money in political campaigns and government decision making, and — in a more disturbing development — the use of recall petitions to undo the will of the people, as is the case this October 7th with the recall election of California’s governor, are ominous signs that weaken representative democracy.

But good governance is not just a government matter, or one restricted to business corporations; it is essential to nonprofit organizations, too. Closer to home — and thanks to the Pulitzer Prize-winning work of the *Boston Globe* and the prosecutorial courage of Massachusetts attorney general Thomas F. Reilly — scandals within the Catholic Church remind us that accountability, honesty, and fidelity to core mission are not flimsy items that can be swept under rugs or robes in the name of the good. American cardinals seem to “have made a hymnal out of the Enron playbook,” as *New York Times* columnist Frank Rich put it earlier this year.<sup>1</sup> Secular charities, too, seem to have forgotten that governance counts, as scandals affecting nonprofits such as the American Red Cross, Nature Conservancy, and United Way continue to surface, calling into question not only their good manners and altruistic acumen but also their commitment and accountability to fiduciary and public interest obligations.<sup>2</sup> Mounting calls for greater accountability from nonprofit groups throw a needed spotlight on the governance and operations of charitable organizations, particularly their oversight duties, fundraising and administrative costs, sources of financing, accounting practices, and other operational information.

But the transgressions of nonprofit organizations pale when compared to the very bad manners and behavior of big business, whose culpability in bad governance is exceeded only by the passivity of those who gained from it. The parade of Enron, WorldCom/MCI, Adelphia, Tyco, Global Crossing, and numerous other perpetrators of corporate wrongdoing remind us that the marketplace sometimes undermines the very virtues and values it is supposed to uphold. We are reminded, too, that not everything can be bought and sold, that intangible goods such as honor, trust, honesty, and integrity are the connective tissue that holds the body politic — and capital markets, equity culture, and civil society — together. Yet equity culture has been hijacked by those who have scorned these intangible goods, violated their fiduciary duties, made a mockery of our financial system, and, in the process, inflicted damage on countless investors and innocent bystanders.

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### **Capital Crime and Punishment**

“It’s Dickensonian,” says corporate governance guru Robert A.G. Monks, whose work over the past 20 years is widely credited with spawning current reform efforts, including the January 2003 decision by the Securities and Exchange

Commission mandating disclosure of proxy voting policies and records by mutual fund managers and investment advisers. (*The Economist* recently dubbed him perhaps America's most distinguished corporate governance activist.) "It's the best of times and the worst of times, because we live in the failure of institutional activism. The smoking gun is not so much the WorldCom, Tyco, Enron — you name it. The smoking gun is the unrestrained pattern of chief executive self-compensation.

This is a reality. The theoretical progress that we felt we'd been making over ten or fifteen years was very rudely confronted by the reality that when there was an issue that was very important to top management, like how much they got paid, they were absolutely unconstrained. That power remains in the hands of the CEOs and they've abused that power. And the institutions have found it convenient not to involve themselves. Another piece of the 'worst times' paragon is that if you look to leadership among institutions in America in 2003 you see fewer names than you saw ten or fifteen years ago, and they're the same names.

The best of news is that not only has the obligation of ERISA [private corporate pension] plans to intervene been confirmed, but the SEC has taken that position with respect to all of the 1940 Act fiduciaries — investment advisers and investment companies — and the bank regulators have said that they are going to pass comparable rules for bank trusts. That was devoutly wished by me 15 years ago, that the 50 percent of voting stock of all American corporations represented by trustees, the scope of whose obligations are determined by federal law, would come to pass. But with that and a dime we can make a phone call is the other side of the question.<sup>3</sup>

Most people are outraged by these abuses, by these insults to our American notion of the democratic ideal, but they adopt Mom's mantra of "This, too, shall pass" without also examining her silent coda: *Don't just sit there, DO something! Do it well, and do it with the courage of your convictions...* All too often they leave the job of mopping up the mess to lawyers, elected officials, and regulators, who, under the white-hot glare of the media spotlight, scramble to litigate, hold hearings, pass laws, and cobble together regulations that will restore confidence and trust. Big business is a great target, because Americans always have been suspicious of vast concentrations of wealth and power — and with the "Wall Street Walk" now overshadowed by the "CEO Perp Walk," there is plenty of reason to be.<sup>4</sup>

The result is a litany of litigation, legal settlements, and formal measures designed to correct or constrain the darker side of human nature. In fact, Monks's latest stab at corporate accountability — he spends a good deal of time in the United Kingdom, where shareholder rights are taken far more seriously, buttressed by English law and government policy — involves the use of shareholder class action suits to force changes in top management and director ranks. He has teamed up with Bill Lerach, a partner at one of the world's most formidable plaintiff law firms, Milberg Weiss Bershad Hynes & Lerach. Milberg Weiss specializes in securities suits and has successfully negotiated settlements for hundreds of millions of dollars with companies such as 3Com, Rite Aid, Sunbeam, and MicroStrategy. The firm currently is representing the lead plaintiff in the shareholder suit against Enron (the University of California, which wants its money back.) Lerach wants to change the way Wall Street investment banks underwrite securities by eliminating indemnity agreements that exempt them from liability. Nicknamed "the king of pain," Lerach is legendary for his casual, flamboyant, tough talking approach; the pair is well matched in what easily could be called the battlefield of the titans.<sup>5</sup>

Litigation aside, Monks has a bigger idea for assuring corporate accountability, which strikes at the heart of who governs. “The corporation code of the United Kingdom and such other Anglophone jurisdictions as Bermuda and Canada is simply this,” Monks said in an interview. “Ten percent of shareholders may as a matter of right call a meeting of shareholders, at which meeting a majority may replace any or all of the directors with or without cause.”<sup>6</sup>

Director removal by majority vote? Similar to California’s recall election (“Recall of the Wild,” as William Safire put it), that is a terrible swift sword in democracy’s arsenal. While this method may square well within a parliamentary democracy, where snap elections are called to bring the ship of state back on course, such a Draconian approach to good governance is not appropriate in American waters (or boardrooms) unless terribly egregious behavior has occurred. Indeed, one is hard pressed to consider how a parliamentary system of corporate governance would work within an American constitutional system of representative democracy. Democracy by plebiscite is not a good idea, particularly in an era of short attention spans and complete media saturation of the public sphere, which cripples public discourse and amplifies the power of even the most marginal groups to extraordinary and undeserved (some would say fictional) levels. In a wired world, there are few filters for sifting through the claims of crackpots and those having more thoughtful, nuanced views.

The more compelling truth is, we have not even begun to look at ways in which shareholders might use our constitutional brand of governance to their advantage, through the use of proxy elections, shareholder conventions, platforms, shareholder / voter education, and so on. Furthermore, since most of the time proxy voting is a non-binding referendum, whether or not it is the final answer to governance failures remains to be seen. No government can be run on the basis of referenda or plebiscite, and even with high votes, the full ramifications and opportunities presented by the proxy franchise have yet to be considered.

Proxy voting is a vehicle for shareholders to have their say; whether or not boards and managers are listening is discretionary, not obligatory.<sup>7</sup> This is a fact that has gone unnoticed until recently, except for those seasoned in the politics of corporate governance. “In recent years we have noticed a trend of majority votes on corporate governance proposals,” noted Kenneth B. Sylvester in an interview held in May 2002. “This has become the real issue because despite the majority votes on these proposals, we find that the boards of these companies have decided not to adopt them.”

Sylvester is assistant comptroller for pension policy in the New York City comptroller’s office, and responsible for developing, researching, recommending, and overseeing proxy programs and policies. The NYC comptroller is the investment adviser to and custodian of New York City’s five major public pension funds, which currently have combined assets of \$69.2 billion. Sylvester, who has been with the comptroller’s office for roughly 20 years, advises the proxy committee of each fund (which are for city employees, teachers, police, fire, and the board of education) and, working with them, initiates and, where the portfolio company is willing, engages in active dialogue with senior corporate executives.

In a game plan followed by most other shareholder activists, in those instances where dialogue has not produced results acceptable to the NYC retirement systems, proxy proposals are then submitted on their behalf for the company’s shareholders to consider and vote at the firm’s annual meeting. The NYC 2002-03 proxy programs included five proposals on corporate governance reforms (one or more of

these were submitted to 25 companies) and eight proposals on corporate social responsibility reforms (one or more of these were submitted to 45 companies). A number of the NYC social responsibility proposals were co-sponsored by other institutional investors and human rights organizations, including the New York State Common Retirement Fund, the Minnesota Board of Investments, the Connecticut Retirement Plans, and pension funds of religious organizations and churches affiliated with the Interfaith Center on Corporate Responsibility (“ICCR”), Trillium Asset Management, Amnesty International, Human Rights Campaign, and Walden Asset Management.

“They’re not abiding by the majority vote of the shareholders,” Sylvester says. “This is an issue of concern, not just in New York City, but also to institutional investors generally. It’s something that’s on the front burner. What’s the next step? Where do we go from here? Where do the shareholders go after we see the majority votes? Not just one year, two years, three years. What do you do next?”

I think what you might see happening in the future is the proxy contest where institutional investors may be coming together to run a short slate of directors to replace management’s elected nominees. An intermediate step is to try and get independent directors to be more responsive to shareholders. While institutional investors focus on the idea of independent directors, I think it’s a matter of form without substance, because despite all these majority votes, there’s no communication between the so-called independent directors and the shareholders.

I think there ought to be some type of system put in place, some type of process or procedure whereby independent directors in particular are required to communicate or provide for communication between shareholders and themselves. Currently, if you try to reach out to a director of a company, there’s always an intervention by management, usually the investor relations office or the general counsel. There’s always that wall that tends to insulate or hide the director from the shareholders who actually elect them. I think it’s a situation that has to be addressed...

The whole concept of independent directors rings pretty hollow to me if there is no real way for expressing your concerns and having them respond to them, or even having them understand the issues better and advocate on your behalf.

The one opportunity that shareholders have to actually meet with management is the annual meeting. Even at those meetings there’s no communication between directors and shareholders. The CEO, or whoever is chairing that meeting, really controls all communications. If a shareholder stands up and asks a question of a director, you might find that the CEO might determine whether or not the director should answer the question, or what the answer should be. So I just think the situation has to be addressed. I think it’s the next step. Perhaps it’s the next step before shareholders begin to wage those proxy battles, or place dissident nominees on the board.

This is an emerging issue, if you will. The phenomenon of majority votes is something that began happening [since about 1994], when we started to see significant votes on issues....If you’re going to talk about corporate democracy in relation to good governance based on a political system like the United States, then it really is a travesty.<sup>8</sup>

Sylvester’s observations, made 17 months ago, were prescient, and have momentous implications. Put simply, amidst all the buzz on corporate governance and shareholder activism, we have seen no serious discussion of a mode of fiduciary governance that corresponds to our constitutional system of political governance, with its checks and balances on power and authority and enshrinement of democratic ideals. The whole idea of American governance is self-governance, and in order to get it you must have accountability, representation, and participation.

These are the three procedural pillars on which our democratic system rests, and as we have seen, are crumbling, at best, in our corporate capital system.

What Ken Sylvester is saying is that the growing levels of shareholder activism and engagement in corporate governance matters do not result in reform. Just as investors are getting used to the power of their vote, they are discovering that in reality their vote does not really count for much at all, other than an expression of sentiment.

An analogy in electoral politics might go something like this: a municipality holds an election for city council, but voters are unable to speak with councilors after they are elected without first going through (or around) the mayor and city attorney.

Another spin on this scenario is: a municipality holds an election for city council, but only a handful of wards and precincts post any returns; most people fail to vote. A minority of registered voters who live in certain neighborhoods elects the winners, who are expected to serve everyone.

Indeed, perhaps the most insidious version of our urban electoral analogue to the way things are done in corporate governance elections is this: a municipality holds an election for city council, but the only candidates allowed on the ballot are those who were nominated by the mayor, council, and top city officials. There is no primary race. The election is held, with only a tiny percentage of voters turning out. After the election, none of the city's residents are able to confer with their duly elected councilors without first encountering the mayor and city attorney, who serve as gatekeepers.

This would never be acceptable in our electoral politics, but this is prevailing practice in corporate governance elections; like Santa Claus, there is really no such thing as corporate democracy, even though that was the way the American corporate governance system was supposed to operate.

Nevertheless, institutional investors offer a ray of hope in the midst of all of this bad governance, in part because a few of them have racked up years of experience and savvy — financial, policy, and political — to reverse the tide of decline. As owners, by law they are able to behave like citizens who possess the franchise; federal legislation, court settlements, and several current SEC proposals are aimed at bringing this shareholder citizen role more into alignment with how the nation's roughly 15,000 publicly traded companies are governed and managed.

One in particular holds the promise of helping to make companies more democratically accountable to shareholders. In July 2003, the SEC issued a staff report prepared by its Division of Corporate Finance in response to mounting calls for a greater shareholder voice in corporate boardrooms. The report also was a follow up to an announcement made in April that the SEC was going to review existing proxy rules and regulations; public views were solicited, yielding commentary from 690 individuals and groups. The vast majority of respondents, which included union leaders, pension fund managers, and large institutional investors, supported modifying the proxy rules and regulations with respect to the nomination and election of directors; opponents included all of the corporations and corporate executives who responded, as well as most of the legal community and business associations.

The suggested new rules contained in the resulting staff report slightly open up the process of director nomination and election; under existing practice, corporate boards nominate themselves for reelection. If they wish, shareholders may withhold votes from a candidate — they cannot vote against a nominee — but if they do, the outcome is still guaranteed because no write-in votes are allowed. Directors are

elected by plurality voting; only those nominees appearing on the ballot are elected, even if there are few votes to count. Should shareholders want to run for office, a full-scale (and extremely costly) proxy fight is required, because shareholders are not allowed to nominate board candidates appearing on the management ballots sent out to shareholders prior to the company's annual meeting.

The suggested new rules — which by late July had not yet been developed into final proposals and issued for public comment — would change this, and make some provision for “eligible shareholders” to run minority seats on the board of directors; the “appropriate eligibility threshold” pertains to share ownership percentages, and at this writing has not yet been set. (Nor had the possibility of multiple shareholder nominees.) Certain “triggering events” would have to occur, however, for the proxy process to be opened to shareholder nominees. Although the details of triggering events were still being worked out, they would serve as objective criteria that demonstrate deficiencies in the proxy process, which prevent shareholder views from being taken into account adequately. The staff report describes them thusly:

Triggering events could include a company's failure to act on shareholder proposals that receive majority votes or the receipt of significant percentages of “withhold” votes in director elections. Another triggering event could be approval of a shareholder proposal to activate the shareholder access rule. Though other triggering events could be used, including economic performance, e.g., lagging a peer index for a specified number of consecutive years, the Division is of the view that any triggering event should be more closely tied to evidence of ineffectiveness in the proxy process.<sup>9</sup>

In spite of these moves, Bob Monks remains pessimistic about authentic governance reform in the United States because, prior to the SEC decision made earlier this year requiring mutual funds and financial advisers to vote, the vast majority of institutional shareholders have chosen not to get involved. He points to the disappointing performance of ERISA (Employee Retirement Income Security Act of 1974) funds, an area he knows well because he served as the Department of Labor's ERISA administrator for three years during the Reagan administration. (ERISA funds are corporate-sponsored pension funds, and are required to vote their proxies.) During Monks's tenure he began pressing his agenda that stock ownership is a responsibility and not simply a property right.

“The golden rule that has resulted is there has been no instance in the last thirty years since the passage of ERISA of a private company pension plan being involved with activism and, horribly enough, not a single instance of the Department of Labor bringing an enforcement action to compel them to be,” he says. But ERISA funds are not the only institutional investors he blames. “The most disappointing quiescent shareholders are the foundations and the universities,” he says, going on to describe what you could call “soft” conflicts of interest produced by their reliance on major donors, which puts them in the uncomfortable position of not wanting to monitor (or bite) the hand that feeds them.

What Monks considers the “virtual failure of all parties who ought to be able to perform the monitoring function” leads him to conclude that litigation is the only fruitful course of action. “I decided that I would affiliate myself with a shareholder plaintiff law firm,” he says, “and attempt to use the leverage of settlements as a way of forcing governance to change ...

[Milberg Weiss has] a whole roster of cases where they've brought shareholder suits that have gotten to the point of discussing settlement with the companies and rather



than just going for damages, which is the corporation writing a check, we are asking the corporations to change their governance. That way the ongoing company is more valuable than the one against whom we got the judgment. It's a big risk whether or not it's going to work, but I felt I had to take my own energy in the next five-year plan and work on the problem from a perspective that had a little more promise.<sup>10</sup>

While it may be too soon to tell if Robert Monks's litigious strategy is the best way to improve corporate governance, he has met with some success, citing February's ouster of Sprint chairman and CEO William Esrey and Sprint president and chief operating officer Ronald LeMay over their use of controversial tax shelters as an auspicious start. "We got lucky," he told *The Economist*, conceding that the Sprint board had already decided to remove the two officers.

Since then, Monks and Lerach have negotiated some fifty corporate governance improvements at Sprint as an alternative to full-blown litigation; Lerach has referred to this as "corporate governance at the point of a gun."<sup>11</sup> Prior to their intervention, Sprint's board was ranked by The Corporate Library ("TCL"), a corporate governance research and monitoring group founded by Monks and longtime partner Nell Minow in 1999, as one of the worst in the country; the company still has room for further improvements, she said in an email.<sup>12</sup>

Minow is in a good position to know about corporate governance matters because she is one of the founders of governance reform and has spent years cultivating her craft; she is widely quoted in mainstream media outlets for her pithy analyses and fair approach. In addition to advocacy, Nell Minow takes seriously the need to educate the public because without an informed citizenry, democracy shrivels up and dies.

In June 2003, The Corporate Library released its latest governance survey of 1,700 companies, which examined board effectiveness. The Board Effectiveness Ratings ("BER") provide a tool for measuring investment risk, and rely on a rating formula that grades companies on an A through F scale. Among the measures used to determine governance effectiveness are executive compensation, board composition, characteristics of certain special peer groupings (such as controlled, family, or stakeholder boards), and shareholder accountability. The latter is exemplified by "appropriate and effective representation of shareholder interest," Minow says, rather than by broader buzzwords of independence and compliance, which may not take into account clearly articulated shareholder preferences.

"Look at the Maytag board," she explains. "They rate quite high according to the typical 'best practice' benchmarks, including director independence. But for three years running they have refused to enact shareholder proposals that were approved by a majority vote. What clearer demonstration of a board's failure to understand their obligation to shareholders can you get?"<sup>13</sup>

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### **Good Intentions Randomize Behavior**

Bob Monks's skepticism regarding genuine governance reform may be justified, but it overlooks one of the lessons of history, which is that remedial action — forced or voluntary — often gives rise to new problems sometimes more stubborn or intractable than their predecessor. Grand or modest, most remedies and reforms are accompanied by new expectations, rules, structures, and procedures that over time may quickly become irrelevant or — as in the case of stock options — may exacerbate the problems they were originally designed to address.<sup>14</sup>

For example, the original thinking throughout the 1990s regarding the now-sullied stock options was that they would serve as incentives for top executives to improve corporate earnings; this has, of course, backfired, as managers continued to reap hefty bonuses and option plans, regardless of poor performance. Activists took notice, and pressured companies to list these options as expenses on the corporate balance sheet; companies had not been doing so, which gave shareholders an artificially inflated sense of corporate earnings and the true value of their shares. Moreover, the outrages over executive compensation — which were boosted primarily by sizable options packages — further fanned the flames. This past July, the SEC decided to require shareholder approval for equity compensation plans, which include options.

Around the same time, Microsoft made big news with its July 8th decision to stop dispensing stock options to its 50,000 employees. Microsoft announced that now it will issue restricted stock, which vests over a five-year period, as a better form of compensation. Yet Microsoft's decision also presents a way out for the company, which, if it expensed the 1.6 billion options outstanding, would have sizably fewer earnings to report. Other companies are expected to follow suit, and exchange options plans for another form of equity compensation.

The idea of using stock options as an incentive for executives was first suggested in the 1970s by Michael C. Jensen of the Harvard Business School and William Meckling at the University of Rochester. Their paper, "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure," stressed the importance of aligning management's interests with shareholders, which in the modern corporation had become more fragmented and dispersed. While the idea remains sound — after all, managers and shareholders share a desire to see a company's share price appreciate by more than the cost of capital — its success is more likely if shareholders pay closer attention to what management is doing, thereby reducing the opportunity for abuse.

Speaking at a recent annual conference sponsored by the Coalition for Environmentally Responsible Economics ("CERES"), Marina Whitman, a business professor at the University of Michigan and former chief economist of General Motors who also serves on a number of corporate boards, said, "Years ago, one of my books recommended the use of stock options, but we never dreamed that they would be abused."<sup>15</sup>

*Good intentions randomize behavior*, as eminent urbanist and former UMass president Bob Wood always used to say. One wonders how Bob's bromide applies to annual board elections, which are so strongly favored by corporate governance reformists. What are they thinking? In electoral politics, annual or biannual elections do little to invite long-range strategic thinking in the interests of both local constituents and the public interest; instead, they reinforce a short-term, risk-averse preoccupation with getting reelected. Even with biannual elections — even quadrennial, if you look at our presidential politics — there exists a strong temptation to slide into a permanent campaign, and as most of us know, there is a big difference between getting elected and governing. As the corporate governance process opens up and greater shareholder involvement with nominating and electing board members becomes the norm, short terms of service may undermine the very fiduciary stewardship ethic reformists intended to install.

Other unattractive features of electoral politics — such as the dominance of special interest groups, professional electoral consultants, excessive campaign contributions, and so on — could easily follow unless carefully thought out

principles and guidelines for civic stewardship — combining representative democracy and wise statecraft — prevail. Good governance, after all, is not just about structure and strategy, but also about soul and substance. The ancients called this “civic virtue.”

Already there are signs of the triumph of consultants’ power over elections, with a virtual monopoly on the proxy process held by a handful of players (most notably, Institutional Shareholder Services, co-founded 18 years ago by Bob Monks and Nell Minow, and the Investor Responsibility Research Center, founded in 1972). Most institutional investors lack a built-in mechanism for handling proxy voting, and therefore rely heavily on the recommendations — however well researched and formulated — of others. Proxy advisory services and information provided by advocates of certain proxy issues can play an important role in helping shareholders, but the full impact of their influence on institutional investor voting remains unclear. The orientation and credentials of these proxy advisers and advocates are never debated, mainly due to their small numbers and relatively limited track records. Even as reputable an institution as the IRRC does not reveal much about its methods, staff, or membership; known for its objectivity and in-depth reporting, it would do well to disclose more about its operations to nonsubscribers.

Besides the problem of monopoly, there are two other related problems with existing proxy advisory service offerings, as well as proxy pressures made on companies by advocates. First, proxy recommendations and vote solicitation are often made without any transparency, accountability, or supporting evidence. In general, positions are defined and advanced, with very little research rationale to back them up. (A notable exception is the work of the Global Reporting Initiative and CERES, which has methodically laid an empirical foundation for linking corporate governance to environmental sustainability.) There is scant information as to the background, qualifications, and experience of those consultants who advise investor clients; in general, they come from the securities industry, and have little knowledge of or experience with public policy and organizational administration.

Second, proxy advisory services are usually rendered without practical knowledge of the organizational requirements for implementation and evaluation. In addition to proxy advisers, shareholders are likely to be bombarded by proponents for a particular cause on proxy issues, whose ideological views may interfere with good decision making. You cannot ask an organization or bureaucracy to do something without a sense of its capacity to deliver. The problems of implementation, we have learned over and over again in the public and nonprofit sectors, often derail even the most well articulated social policy possessing broad-based political or donor support. There is no reason to presume a similar fate regarding proxy resolutions — even if boards did adopt them.

In addition to the absence of educational and training programs, I often have wondered why there are so few organizational specialists or policy experts among the legions of socially responsible investing professionals or corporate governance activists, and so little focus on organizational development and implementation, or the broader policy context, at their conferences and gatherings. You cannot have governance reform without institutional reform, and you cannot push a social policy agenda without understanding the broader issues involved, but practitioners in these areas seem to occupy multiple parallel universes.

Some — most notably Steve Lydenberg, one of the most experienced and thoughtful practitioners in the social investing field, and Monks and Minow, with

their establishment of The Corporate Library and continued public service work — have spoken out on the need for expanded and higher quality educational offerings in the realms of business ethics, socially responsible investing, corporate governance, and corporate responsibility. The time is long overdue for professional development in the duties of both governance and ownership. This is an ironic state of affairs for those board members, social investors, and governance activists who otherwise claim to be acting in the best interest of shareholders.

Nevertheless, corporate governance reform related initiatives continue to appear at a brisk pace, producing what some have dubbed “corporate governance fatigue.” Business ethics consultants are once again in great demand, business schools are scrambling to offer courses and executive training sessions on ethics, corporate social responsibility, and corporate governance, and monographs and dissertations on ethical corporate behavior churn out at a furious pace. (In fact, according to *Business Ethics* magazine, California state senator Richard Alarcon has filed a bill that would require business students, both undergraduate and graduate, attending California public colleges and universities to take ethics courses. California Senate Bill 821 would also create a state ethics commission.)<sup>16</sup>

When it comes to corporate governance, what we have is a new line of business opportunities. A cottage industry of corporate governance and monitoring experts has mushroomed, lucrative board advisory and ratings services have blossomed, database giants and technology consulting firms (which hawk automated tools and advice for handling the new transparency data demands) have enjoyed new life after the dot-com meltdown, and a number of specialty books have been published, providing insiders’ views as to why things happened as they did, and what should be done about it.<sup>17</sup>

Aside from the money spent on records management and business process management, you have to wonder if all of this activity will really make a difference, and if it is necessary to pay large amounts of money to people to teach and advise what ought to be just plain common sense. Plus, there are no ways of screening so-called experts (many of whom are public relations experts, management consultants, and investment bankers), and whether or not their experience will help to improve corporate governance and operations. Most of the consulting fees — estimated to reach \$2.5 billion this year — will be spent on regulatory compliance, rather than a genuine commitment to upgrade shareholder, board, and management knowledge, competence, and behavior, or developing new governance models that integrate democratic ideals while remaining true to core mission. A notable exception among the legions of advisers is McKinsey & Company, which has conducted solid corporate governance work for the past 10 years and recognizes that good corporate governance involves every element in the organizational system. Since 2000, McKinsey survey research has shown that a significant majority of institutional shareholders will pay a premium for well-governed companies, and that corporate governance now lies at the heart of investment decisions.

“Everybody knows what they are supposed to do and they should just go do it,” says Ira Millstein, attorney and prominent corporate governance specialist, referring to board responsibilities and the boom in governance consulting. “This is not tough stuff, this is not rocket science. The only technical piece of this is the audit committee ... The rest of it is just plain common sense, knowing the business, going to meetings, not falling asleep, paying attention and keeping your eyes on the CEO.”<sup>18</sup>

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## The Need for a Fiduciary Creed

These governance educational and consulting services stem primarily from two legal and regulatory developments over the past 18 months that shook the foundation of capital markets and imposed sweeping new requirements. They serve as twin beacons — one initiated by state prosecutors and culminating in an eventual settlement, the other by congressmen eager to take a stand against investor losses caused by financial fraud — for somewhat better days ahead. The stock exchanges also proposed new listing standards and rules, particularly with respect to director independence and reporting. Even if human nature dictates that there will always be crooks and corporate scandals, thanks to last April's \$1.4 billion settlement affecting ten Wall Street investment banks and last year's Congressional passage of the antifraud Sarbanes-Oxley Act the crooks will find the going's gotten a bit tougher, with the Federal government paying closer attention and with sanctions more severe.

These actions, however laudable, are not enough, because a host of critical questions remain unanswered. Most of them relate to the *investor* part of the investor/corporate equation. After all, companies are not untethered from those whose money was put at risk to finance them. Still absent is a fiduciary creed that articulates a set of beliefs and principles about the moral obligations of equity ownership.

A sampler: Will these any of these actions succeed in restoring investor confidence and trust in our economic systems? Will they succeed in installing and sustaining responsible ownership and fiduciary governance regimes that assure such corporate perversions do not happen again? Will they succeed in assuring the minimum fiduciary and legal obligation to achieve the greatest possible asset value, through a trustee ethic of duty, care, and consistency? Indeed, will these myriad corporate governance reform actions succeed in assuring not merely the minimum fiduciary and legal standard, but one that surpasses it, exploiting investment assets to their fullest and embracing the normative realm of ethical principles and values consistent with our democratic tradition?

More importantly, do these actions acknowledge the explosive growth in institutional stock ownership — including mutual funds, pension funds, insurance companies, and endowments — since the 1980s, which now controls almost 50 percent of U.S. corporate equity and a sizable portion of the economy as a whole? Do these actions address, because of their enormous size and potential power, the constructive role these institutional investors can play to influence *corporate accountability to fiduciary standards*, and incorporate ethical and civic moral values in doing so?

In addition to corporate governance, do these reforms recognize the constructive role these institutional investors can play to influence *the broader economic environment*, and how their decisions impact whole industries — perhaps even world politics and economic development? Beyond monitoring, do these reforms address the constructive leadership role these institutional investors can play to *set a positive agenda for corporations and industries on important matters of mutual interest*, consistent with the fiduciary ethic and our democratic ideals?

Indeed, do these actions help us understand what constitutes good fiduciary governance — including the use of otherwise “wasted assets,” such as the proxy vote and whether or not investor boards of directors are displaying it? Do they acknowledge the growing intensity and clout of investors on corporate behavior — particularly with regard to CEO pay and global warming — as expressed through

filing and voting shareholder resolutions? Do they provide guidance as to what companies should do when resolutions receive high percentages of “yes” votes, when the company tradition is to ignore them? As already mentioned, as it now stands, companies do not have to do anything, although suggestions contained in a staff report issued by the SEC in mid-July would give shareholders greater power to nominate and elect corporate directors in the event the board ignores shareholder preferences.

In fact, this year was a banner year for proxy voting, with more than 1,040 resolutions filed — a 20 percent increase, according to the Investor Responsibility Research Center (“IRRC”), over last year’s total of 802. The gain was particularly dramatic for corporate governance resolutions, particularly those related to executive compensation (325 in 2003, up from 106 in 2002), separation of the roles of chairman and CEO (27 filed in 2003, compared to 4 in 2002), and offshore tax havens (a new issue on the proxy docket, submitted by labor related funds and directed to Carnival, Cooper Industries Ltd., Ingersoll-Rand, McDermott International, Schlumberger Ltd., Transocean, and Tyco International).

Shareholder resolutions also were filed on various social policy and environmental issues; roughly 238 were filed this season, a slight increase over the number filed last year. Topping the list was global warming; led by a coalition of environmental, religious, and pension funds, 31 global warming resolutions were filed with 23 U.S. and 5 Canadian companies this year, including those in the automobile, electric power, and oil industries. Others included sexual orientation anti-bias policies (19 filed in 2002, more than the nine filed in 2002), fair employment policies, and reporting on greenhouse gas emissions. Several websites provide up-to-date information on the status of shareholder resolutions, including The Corporate Library ([www.thecorporatelibrary.com](http://www.thecorporatelibrary.com)), Domini Social Investments ([www.domini.com](http://www.domini.com)), the Investor Responsibility Research Center ([www.irrc.org](http://www.irrc.org)), the Interfaith Center on Corporate Responsibility ([www.iccr.org](http://www.iccr.org)), the Coalition for Environmentally Responsive Economics ([www.ceres.org](http://www.ceres.org)), and the Shareholder Action Network, a joint project of the Social Investment Forum and Coop America ([www.shareholderaction.org](http://www.shareholderaction.org)).

More than appeals to conscience, most of these proxy resolutions concerned the potential financial risks associated with a company’s social and environmental stance. According to Timothy Smith, one of the nation’s leading experts on corporate accountability and shareholder activism, “It is clear that 2003 will be remembered as the year when investors decided to stand up and be counted, using their voice and vote to call for strengthened corporate governance and solid corporate citizenship. Investors are moving from passive holders of stock to becoming active and responsible owners... understanding the leverage they have as individuals and institutions who have invested their capital and faith in these companies.” One of the founders of the Interfaith Center on Corporate Responsibility (“ICCR”) serving for 25 years its executive director, Smith is currently senior vice president and director of socially responsive investing at Walden Asset Management, a Boston-based money management firm; he also is president of the Social Investment Forum, the national trade association for the social investment industry.<sup>19</sup>

This view on risk exposure to environmental hazards is echoed by Mindy Lubber, executive director of CERES, who points out the overlap between the financial and nonfinancial domains. “Climate change risk is not just an ‘environmental’ issue. It is directly related to the bottom-line viability of several American industries, including oil, utilities, and autos. In the wake of scandals at Enron and

other corporations, investors are now wide awake to the issues of risk, and the awareness that all too many companies are not doing enough to assess, report, and mitigate these dangers to shareholder value. The increasing shareholder focus on climate change issues shows how such ‘hidden risks’ can no longer be swept under the carpet by unresponsive managers.”<sup>20</sup>

In July, CERES released a study of some of the world’s largest companies that revealed that they are not adequately assessing, disclosing, or addressing the financial risks posed by climate change. Researchers found that the 20 companies examined in *Corporate Governance and Climate Change: Making the Connection*, including ChevronTexaco, ExxonMobil, General Electric, Southern Company, and Xcel Energy, “also are failing to deal with global warming issues in other key corporate governance areas...The companies profiled in the report include the top five carbon emitters in electric power, auto and petroleum industries as well as five other industry leaders — all core holdings in institutional investment portfolios. A 14-point ‘Climate Change Governance Checklist’ analyzes these companies’ response actions in the areas of board oversight, management accountability, executive compensation, emissions reporting, and material risk disclosure.” The report was commissioned by CERES and written by the Investor Responsibility Research Center; a copy is available from CERES by visiting its website [www.ceres.org](http://www.ceres.org).<sup>21</sup>

In addition to a record number of resolutions, the 2002-2003 proxy season featured record-high votes: two corporate governance resolutions, at Avon and Baker Hughes, received 80 percent shareholder approval. On the social and environmental side, the average 2003 support for resolutions filed with electric utilities as well as oil and gas companies was 22.6 percent, much higher than in previous years.<sup>22</sup> (As of this writing, final vote tallies for most proxy contests had yet to come in. Unlike electoral politics, when often the outcome is known even before the polls close, proxy campaigns remain undecided for weeks.) Even though the vast majority of proposals are nonbinding, high voting percentages send a clear message to company management about shareholder preferences and opinions.

Another indicator of investor power is the extent of shareholder / company communication, demonstrated in part by the number of shareholder resolutions that are withdrawn because of company willingness to fulfill the resolution’s request or engage in important dialogue with shareholders. Yet when looking at the regulatory and statutory landscape, in particular the 30 July 2002 passage of the Sarbanes-Oxley Act and the \$1.4 billion Wall Street settlement, one is hard-pressed to find references to the significant role that owners can play in improving corporate governance and accountability. Although the idea of fiduciary leadership and governance is hinted at (mainly concerning investor education and proxy activism), it is vastly overshadowed by the plethora of penalties, rules, review committees, and structural remedies.

Indeed, one should ask if these actions acknowledge the tangible implications of fiduciary governance, including institutional investor recognition of other forms of power at their disposal to promote corporate accountability, such as the “soft” power of framework and agenda setting, information and expertise, dialogue, persuasion, and formation of alliances and networks with others having shared concerns?

Do these actions facilitate better shareholder representation, consistent with our republican tradition; for example, do they clear a path for shareholder nomination of corporate board candidates, which in theory is how the corporate governance system is supposed to work anyway? Some movement on this question has occurred, which is promising. Last July the SEC’s Division of Corporation Finance prepared a report

concerning its review of current regulations regarding the nomination and election of directors and recommended improved disclosure and improved shareholder access to the process, which is now under consideration.

As for the shareholders themselves, do these corporate governance reform actions promote greater trustee knowledge and competence within institutional investor boards? Similar to the rash of corporate governance ratings services, do they help in the formulation of a normative framework and empirical guidelines for monitoring and comparing fiduciary boards, to identify best practices and promote them? Do they help us define what it means to be a good investor?

Put another way, do these various corporate governance reform actions pave the way for a creed of responsible ownership and fiduciary governance, which I call “civic stewardship”?<sup>23</sup>

Sadly, the answer to most of these questions is a resounding No. As renowned corporate governance expert Nell Minow has pointed out, most reform measures are focused on the “supply” side of corporate scandals, affecting the companies themselves, rather than the “demand” side of equity ownership, now dominated by institutional assets. With two significant exceptions — last January’s SEC ruling that mutual funds adopt and disclose proxy voting policies, the triumphant culmination of a process Minow and her longtime partner Bob Monks initiated in 1988 with their letter to the SEC seeking these changes, and bolstered by a massive transparency campaign led by the AFL-CIO, Teamsters, and Domini Social Investments,<sup>24</sup> and the July 2003 SEC staff report on director nomination and election — none of these reforms focus on how investors might better exercise their rights and responsibilities as owners. Even though common sense tells us they should do so, none of these corporate governance reform measures provide a blueprint for fiduciary governance that reinforces the system of checks and balances that already exists and shows investors how to properly discharge their responsibilities, while reinforcing an ethic of civic virtue and the democratic ideal. Business does not function in a vacuum, and capital markets do not work in an environment of greed, deceit, and tyranny.

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### **The Enron Effect: Good Governance = Good Ownership + Good Citizenship**

As for ethics and values, before Enron, critics often argued that morality had no legitimate role in economic decision making, particularly portfolio management, because it might weaken financial acumen or interfere with positive rates of return. Before Enron, they claimed that equity investments should be judged on the basis of financial performance alone because investors have only financial equity at risk, and that this equity — indeed, the corporation itself — is a *persona ficta*, lacking a soul. Before Enron, critics argued that the best judge of corporate responsibility and character lies either within the marketplace or the legal-regulatory system, and that “do-gooders” should leave well enough alone.

But as we have seen, theirs was not a valid argument. As we have come to recognize painfully, there is a great deal of “free space” between society’s laws and the behavior of the market, free space in which corporations and capital do their thing, sometimes to the detriment of those very owners whose equity is at stake, not to mention innocent bystanders with little or no standing in the game. Moreover, neither the marketplace nor the law is adequate to the task of protecting society from the damages that can be inflicted by excessive speculation, potential



monopolies or oligopolies created by mergers and acquisitions, or the widening gap between the haves and the have-nots. (You could make the argument that the problem with world poverty is not so much the problem of capital inequalities, but of the failure of governments and market economies, which includes institutional investors, to alleviate it. But that's another topic, for another day.)

Yet most of the time, financial criteria rather than non-financial criteria are the template which most corporate owners use to measure the value of their investments and the performance of corporate managers. They do not consider the moral location of the economy and therefore do not view corporate institutions as reflecting moral and political norms. They view the corporation and its performance as separate from politics and ethics rather than embedded in it. So, too, do they see themselves as separate from a political and ethical regime, even if their primary missions have distinct social or charitable or political qualities.

This is a misleading perspective because *corporations and industrial sectors are not value-free*. Contained within their structure and operation are assumptions about what is considered "good" and "right," "right" or "wrong," assumptions that become more coherent and fully developed as the institution or sector cultivates its specific culture or character. These assumptions, clouded as they may be by the language of financial statements and quarterly reports, serve as the compass that guides corporate decision-making and communication. Putting the point another way, behind the numbers lie certain first-order principles or values — a company's moral sense, if you will — that need to be made more explicit, as many thoughtful observers have recognized.

A striking example of the connection between economic activity and the moral realm is the semantic similarity of financial and ecclesiastic vocabularies. Terms such as "good," "equity," "value," "mission," "custodian," "trust," "denomination," "capital," "prudence," "vest" and "invest," "redemption" and "redeem," "debt," "saving" and "save," "bond," "promissory," "futures," and "dispensation" are examples of words with double meaning. In fact, the word "economy" comes from the Greek "*oikonomia*," which meant "management of the household," with the household connected to the production, distribution, and consumption of life's necessities. *Oikonomia* is a multifaceted word that sometimes is translated as "stewardship," itself a first cousin of "fiduciary," which means a designated agent occupying a special relation of trust, confidence, or responsibility in obligation to others.

Notions of "fiduciary responsibility" are not absolute; they are relativistic concepts that have evolved over time. The idea of a fiduciary relation to a fund of money is rooted in English common law but the legal concept of the "prudent man" was expressed in a case involving Harvard College 173 years ago.<sup>25</sup> The scope of fiduciary responsibility as applied to institutional investors is subject to definition by federal agencies under existing laws. These agencies include the private pension system subject to the Employee Retirement Income Security Act of 1974 ("ERISA") and the Department of Labor; investment companies subject to the 1940 Investment Act and the Securities and Exchange Commission; bank trusts subject to the Federal Reserve, the FDIC, and the Comptroller of the Currency; and public pension funds, charities, and endowments subject to the Internal Revenue Service, as well as state laws and the offices of attorneys general.

Under the laws pertaining to the fiduciary role, board members have three duties to consider in maintaining a trustee's standard of care. The first is to *act as a prudent person* might act in similar circumstances. The second is to *avoid conflicts*

*of interest.* The third is to assure that the *organization operates consistently*, in keeping with the rules and laws governing its formulation, and in accordance with its bylaws and mission. Generally speaking, these duties entail full exercise of the legal rights of ownership, which includes the purchase and sale of assets, voting proxies, conveying concerns to corporate boards and management, submitting proposals for shareholder action at annual meetings, convening shareholder meetings or joining forces with other investors and interested parties on issues of mutual interest, taking legal action, conducting equity research, hiring outside specialized agents, and so on.

Thanks to a handful of corporate governance activists, governance concerns are now considered a significant part of the fiduciary role, even though the focus is on companies rather than on an investor's own governance regime. There is significant room for addressing fiduciary leadership and governance. Similarly, there is room for addressing the "consistency" standard, meaning the extent to which an organization's investment policy and practices integrate the ideals, values, and principles embedded in its mission statement. The challenge of aligning investment decisions with institutional mission — with the lowest possible risk of adverse impact — has yet to be fully met. Certain beneficial fiduciaries, most notably the \$550 million Boston Foundation, socially responsible investment funds, many religious investors, and a number of prominent pension funds have broken important new ground in this territory and serve as models for others to emulate.

In addition to the meaning of "fiduciary," we also need to be clear about what "economy" is and what it is not. "Economics" is an array of analytic tools that apply to diverse situations. It is not a rigid set of universal principles, nor is it a roadmap for how we should live our lives. What *oikonomia* and economics both have in common is recognition, since the time of the ancient Greeks, that there was no sharp boundary between economic matters and those having to do with social status, politics, and ethics. The "natural" economy of the household and the world of the market, as Aristotle taught us, could either advance or undermine the good life, freedom, and community.<sup>26</sup>

We have come a long way from Aristotle, but the essential truths remain the same. Nowadays, although it may provide a glimpse, the marketplace is not a good gauge of the moral sense of society, or of its institutions. It cannot help us understand what kind of a world we want to live in, what our aspirations are, or how things might be better. In fact, the marketplace does little to help us maintain our civic moral bearing. It does little to preserve basic fairness, or justice, or truth telling. It does little to help us aspire to greatness, the stuff of which our democratic way of life is made. In fact, within the globalized consumer economy, these values and democratic ideals have become corroded, with civic virtue giving way to crass commercialism and a consumer ethic of unbridled consumption.

Yet after Enron and its siblings, we are reminded that corporate profitability and stock price value provide only a distorted picture of society's well-being, or of the extent to which human dignity or freedom are honored. After Enron, we are reminded that commercialism and consumerism are not enough, that some goods cannot be bought and sold, and that we have a long way to go before our dynamic global economy can produce a decent global life.

Returning to the purpose of this article, however, we confront the challenge of governance, particularly how best to muster the courage and will to improve the way in which institutional investors handle equity investments. We need to do so because equity investments carry rights and responsibilities, as well as risks and

rewards, and because the notion of “equity,” as already has been pointed out, carries both financial and moral meaning.

Taken literally, equity means “standing,” that one has a stake in an entity, whether it be a company, as in stock ownership; in a society, as in fair treatment or social justice; or in a relationship, as in an equitable right or claim. As British historian Anthony Everitt tells us in his superb biography of Cicero, in ancient Roman society the notion of *equites* referred to a class of citizens having commercial concerns; *equites* were the landed gentry, businessmen, and merchants who tended to avoid national politics. Originally a military class, *equites* meant “knights” whose wealth enabled them to buy a horse for military campaigns. Within the Roman social hierarchy, *equites* ranked below the aristocracy, yet were above the *plebs* — that is, the urban masses, including shopkeepers, artisans, and landless farmworkers — and, at the very bottom, the slaves.<sup>27</sup>

Thus in many ways, “equity” denotes “citizenship.” A contemporary notion of equity as citizenship was elaborated by the late Harvard government professor Judith Shklar as social *standing*, meaning inclusion and respect, symbolized by the opportunity to vote and to earn a living as well as participation, accountability, and representation in the polity. One can only speculate as to how much we would have gained, had she lived to enlighten us, by hearing her tackle the question of citizenship as applied to shareholders, particularly institutional investors.<sup>28</sup>

With regard to human endeavors, “equity” takes on special importance because it suggests a capacity to be involved, to participate, to be in a position to chart one’s course, to be engaged in a process of self-governance. As applied to social capital, “equity” is a cornerstone of democratic civil society. As applied to human capital, “equity” is a tenant of nondiscriminatory labor policies. As applied to financial capital, “equity” is a fundamental fixture of open markets and effective capitalism.

Whatever the capital domain — social, human, and financial — “equity culture” relies on certain virtues, or else it faces collapse. The least of these is *trust*, so that decisions can be made based upon truthful and reliable information, that these decisions are guided by principles of ethics and fairness, and that “access to equity” is not just a right but a responsibility, a responsibility for strengthening equity culture for generations to come. Another requirement for equity culture is *knowledge*, so that one’s stake in an entity can be managed in a way that promotes growth and development, prosperity and well-being. A third is *sustainability*, so that this growth and development can continue, without inflicting injury or falling victim to the dangers of greed, ignorance, or hubris.

“Prosperity in the Anglo-American world since World War II has in large measure been due to the success of equity culture,” says Bob Monks, the widely acknowledged founding father of the shareholder activism and corporate governance movement. “Savers around the world search for a mode of investment through which they can earn the highest return at acceptable risk.

Common stock of publicly traded companies provides investors with a particularly attractive blend of reward and risk, but only so long as they feel that the market is honest. Governance is about providing this assurance. Only if investors are convinced that (1) they are making decisions to buy based on reliable information and (2) that management is running the enterprise for their benefit will the marketplace value stocks attractively. It is the element of trust on which the world’s wealth depends.<sup>29</sup>

The call for common sense and civic virtue, responsible ownership, and fiduciary governance, seeks to strengthen equity culture by promoting civic stewardship

principles, standards, procedures, and trustee knowledge and competence. The goal is to help institutional investors fulfill their fiduciary obligation in a manner that balances long-term financial prosperity with the common good, a noble idea with ancient roots and enshrined within our democratic ideals.

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### **Restoring Good Governance in Politics and Civil Society**

Before turning to our examination of governance in the private sector, we need to remember that the governance crisis affects our civic and public life, too. The remedies cut across these sectors, suggesting new forms of participation and solidarity that will revitalize civic democracy. Theda Skocpol, professor of government and sociology and director the Center for American Political Studies at Harvard University has studied the interplay of democratic politics and civic voluntarism in the nation's history. In an important new book called *Diminished Democracy: From Membership to Management in American Civic Life*, Skocpol addresses the problem of governance in a manner that unintentionally reinforces the message of this article: that our politics has become dominated by big institutions which are poorly governed and diminish democracy, but that institutional investors are in a position to improve matters through proper exercise of their fiduciary role.

Skocpol shows, contrary to prevailing wisdom on both ends of the political spectrum, that American civic voluntarism “was never predominantly local and never flourished apart from national government and politics.” She claims that, “Americans joined and led voluntary associations not merely to interact with friends and neighbors and solve local problems but also so as to reach out to fellow citizens of a vast republic and build the organizational capacity to shape national culture and politics.” She goes on to challenge “the liberal article of faith” that American society has become steadily more democratic since the 1960s, and asserts that while the various struggles for civil rights, women's liberation, world peace, and other public interest causes broke down old barriers to full participation and put new issues on the public agenda, “the social movements of the 1960s and 1970s also inadvertently helped to trigger a reorganization of national civic life, in which professionally managed associations and institutions proliferated while cross-class membership associations lost ground...The professionally managed organizations that dominate American civic life today are, in important respects, less democratic and participatory than the pre-1960s membership federations they displaced.”<sup>30</sup>

What we need to strengthen our democracy and civic life, Skocpol tells us, are not the currently popular remedies of smaller government, more local community and intimate social participation, or more government subsidies of faith based institutions, because these proposals can do more harm than good.<sup>31</sup> “To correct for recent civic losses and revitalize American democracy, we must find ways to nurture national solidarity as well as local community,” she writes. “And we need national-level reforms with bite, targeted on powerful institutions and nationally ambitious activists...Leaders who understand the democratic deficits of our overly professionalized and elitist contemporary civic life can devise new models of association building, blending the best of the old and the new civic America.” A good place to start is with “fresh strategies for civic organizing,” and measures that concentrate on making the national media, elections, and government supportive of renewed democratic vitality in American civil society.<sup>32</sup>

“Over the past third of a century, the old civic America has been bypassed and shoved to the side by a gaggle of professionally dominated advocacy groups and nonprofit institutions rarely attached to memberships worthy of the name,” Skocpol concludes, a perspective that could well be applied to business enterprise and lobbyists, too. “Ideals of shared citizenship and possibilities for democratic leverage have been compromised in the process.

Since the 1960s many good things have happened in America. New voices are heard, and there have been invaluable gains in equality and liberty. But vital links in the nation’s associational life have frayed, and we need to find creative ways to repair those links if America is to avoid becoming a country of managers and manipulated spectators rather than a national community of fellow democratic citizens.

There cannot be any way of going back to the civic world we have lost, but we Americans can and should look for ways to re-create the best of our civic past in new forms suited to a renewed democratic future.<sup>33</sup>

Large or small, you have to laud the various attempts to improve things, and hope for the best. But as many commentators have pointed out, some major obstacles must be overcome before “good governance” makes a comeback and our democratic ideals are fulfilled. First and foremost is genuine campaign finance reform, which received a recent setback when a three-judge federal court issued a split decision in a lawsuit challenging McCain-Feingold, the landmark law aimed at reducing the corrosive role that money plays in politics; while as of this writing, the full impact of the panel’s ruling had not become clear, it will not detract from eventual Supreme Court consideration of whether Congress has the right to impose limits on campaign contributions and expenditures so as to assure integrity in the electoral process. As it stands, we get what other people pay for when it comes to political leadership in public life.

Besides money, another obstacle to good governance and our democratic ideals is our disturbingly low level of political literacy and voter participation. While the numbers continue to be high regarding American civic engagement, these data do not translate into political awareness, involvement, and participation: In 1998, 70 percent of American households gave money to worthy causes (with an average contribution of \$1,075), and 55.5 percent (109.4 million) of Americans volunteered their time. Yet in 2000, the last major election year, only 51.3 percent of Americans who are eligible to vote did so, according to the Federal Election Commission (“FEC”).<sup>34</sup>

The “Vanishing Voter Project” at Harvard’s Kennedy School of Government was organized to understand the greatest threat to democracy: ourselves. Thomas E. Patterson and news legend Marvin Kalb are co-directors of the project, which tracked voter participation and attitudes during the 2000 presidential campaign. “The period from 1960 to 2000 marks the longest ebb in turnout in the nation’s history,” Patterson writes in his survey analysis. “Fewer voters are not the only sign that Americans are less interested in political campaigns. Since 1960, participation has declined in virtually every area of election activity, from the volunteers who work on campaigns to the viewers who watch televised debates.”<sup>35</sup>

So what do these numbers tell us? One answer: We seem to take for granted a democratic franchise for which others around the world are willing to lay down their lives. Another unsettling one: We may be generous in our giving and volunteer work, but we leave public governance to others, particularly those with deep pockets or professional advocacy ties.

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### **Power and Accountability: Public Defenders and Regulators React**

Let us now return to governance as applied to capital markets and corporate ownership and management. On April 28, 2003, regulators announced the final agreement in a landmark \$1.4 billion global investment banking settlement regarding conflicts of interest among Wall Street stock research analysts who issued overly optimistic ratings to attract investment banking business. At SEC headquarters in Washington, Eliot Spitzer, the New York State attorney general, and William H. Donaldson, the new chairman of the Securities and Exchange Commission, announced the formal charges and settlement agreement affecting ten of the nation's biggest securities firms. "These cases reflect a sad chapter in the history of American business, a chapter in which those who reaped enormous benefits based on the trust of investors profoundly betrayed that trust," said Donaldson. "The cases also represent an important new chapter in our ongoing efforts to restore investors' faith and confidence in the fairness and integrity of our markets."

The settlement, which hinges on the approval of U.S. District Court Judge William H. Pauley in Manhattan, is widely viewed as changing the way major investment firms do business and has repercussions that will be felt for years to come. It also is expected to unleash a firestorm of class-action lawsuits against the firms, brought by investors who believe they lost money because of tainted research and who now have powerful legal ammunition to argue their cases. "This is not the end — this is very much the beginning for those who acted improperly," Spitzer said at the announcement, referring to the thousands of class-action cases pending in courts nationwide. "Everyone won except the investors." (The settlements do not preclude government officials from further investigation. "Just wait," warned Steven Cutler, the SEC's head of enforcement and a leading architect of the agreement, referring to the possible failure of top executives at the investment firms to provide adequate supervision to analysts.)<sup>36</sup>

The securities settlement agreement commits the "tainted ten" to a series of penalties and reforms, including the \$1.4 billion payment that is divided into four parts:

- *penalties* (\$487.5 million);
- *restitution* to investors (\$387.5 million);
- a special "*independent-research*" fund (\$432.5 million); and
- an "*investor-education*" program (\$80 million), some of which will also go to the states.

Of the overall \$1.4 billion stock-analyst settlement, \$399 million will go to the SEC and \$495 million will go directly to the states. The SEC will transfer its \$399 million to a so-called "Fair Fund," a restitution fund providing eventual reimbursement to aggrieved investors; this process is expected to be lengthy and complicated, according to SEC officials.

The states' share will be distributed according to population; Massachusetts is expected to receive \$7.8 billion, smaller states such as Maine and Rhode Island are expected to get just under \$4 million, and California, as the biggest state, will receive roughly \$43 million. Rather than directing money to investors, most states will probably use the proceeds to alleviate the damage caused by crippling budget

deficits; roughly half the states, including New York, Texas, Massachusetts, and Maine, are required by state law to deposit their share of the penalties and fines into the state's general fund.

In addition to the \$487.5 million in penalties, the brokerage firms have agreed to pay \$432.5 million into an independent-research fund, with seven of the ten paying \$80 million into an investor-education program. On the latter, the SEC, New York Stock Exchange, and National Association of Securities Dealers ("NASD") will use \$52.5 million for an Investor Education Fund, overseen by an Investor Protection Trust ("IPT"), with the remaining \$27.5 million paid to state securities regulators for investor education. At the April press conference announcing the settlement, both Spitzer and Donaldson claimed that the investor-education fund would have far-reaching benefits.

In May 2003, Judge Pauley told the SEC that he wanted more information as to how the settlement money would be returned to investors, used to educate the public, and pay for independent research. The SEC responded in mid-June with a filing that suggested "an administrator appointed by the court should decide who should get payouts from the settlement and in what proportion," according to the *New York Times*.<sup>37</sup>

As of this writing, no further information could be obtained regarding the implementation of the settlement agreement. There are some clues as to the ways and means of distributing the investor education funds, but no information regarding the substance or content of investor education, beyond general reference to national and local distribution channels. Pending court approval, the Investor Protection Trust is expected to be the grantmaking agent, with a proposal review and grantmaking process currently under construction; the IPT expects to begin its grantmaking activities in the summer/fall of 2003, according to information posted on its website at [www.investorprotection.org](http://www.investorprotection.org).<sup>38</sup>

In spite of what appears to be an above-board process, one cannot help but think that the fix is in, or at the very least, behind the scenes jockeying for this money has already begun. A fair and open process of decision making is vitally important to determine how the money will be spent, just what is meant by "investor education", and the criteria and methods for accessing funding to carry it out. Also needed is an objective, authoritative, and informed mechanism, perhaps a Commission on Fiduciary Education, that can develop a set of principles and standards for investor education and training, which improves their capacity to discharge their fiduciary roles and responsibilities effectively. Someone of the caliber of former SEC chair Arthur Levitt, who was an outspoken advocate of investor education, to preside over any such initiative would bolster not just investor confidence, but demonstrate that ownership is a responsibility, not an entitlement.

The settlement caps a process begun in the wake of the series of accounting scandals affecting such big companies as Enron, WorldCom, Global Crossing, and Tyco. It eventually put some of Wall Street's most prominent investment firms in the crosshairs of public prosecutors and regulators, and now they will have to pay for their sins. Citigroup, Inc. and its brokerage business, Salomon Smith Barney, will pay the biggest fine, \$300 million, plus \$75 million toward the independent-research fund and \$25 million to the investor-education program. Credit Suisse Group's Credit Suisse First Boston unit has agreed to pay combined costs of \$200 million; so has Merrill Lynch & Co. Morgan Stanley Co. will pay \$125 million; Goldman Sachs Group Inc. will pay \$110 million; and Bear Stearns Cos., J.P. Morgan Chase & Co., Lehman Brothers Holdings Inc., UBS AG's Paine Webber,

and US Bancorp's Piper Jaffrey unit will each pay \$80 million in combined penalties and payments to the independent-research and investor-education funds. (One brokerage firm not covered by the agreement was Deutsche Bank AG, which has agreed to pay a \$50 million fine.)

The investigation began in 2001, when attorney general Spitzer opened an inquiry into the research practices of Merrill Lynch, which continued to recommend Internet stocks after they had lost much of their value. After winning a \$100 million settlement, Spitzer — widely expected to make a bid for New York's gubernatorial seat — then expanded the investigation to a dozen other firms. Other regulators and industry groups, including the SEC, the state regulators' trade group, the National Association of Securities Dealers, and the New York Stock Exchange, joined in.

In December 2002, the group announced a tentative framework for a comprehensive settlement, in which the firms neither admitted nor denied guilt but agreed to pay the \$1.4 billion fine. Furthermore, they are obliged to separate their stock research operations from their investment banking activity, establishing a "clear bright line" that will prevent conflicts of interest between bankers and analysts. The agreement also prohibits the practice of special treatment, called "spinning," provided to privileged banking clients who were given advance notice of upcoming public stock offerings, at the expense of smaller investors. Indeed, securities firms must disclose whether they do business with the companies they are analyzing.

What remains to be seen, however, is the extent to which the announcement truly changes the way business is done, particularly in an era when "pure," "unconflicted," or "untainted" information is hard to come by. Since the October 1999 repeal of the Glass-Steagall Act, which eliminated the traditional barriers between the commercial and investment banks, just about anything goes in the financial services industry.<sup>39</sup> In a wired world with electronic communication making any kind of information instantly accessible, it is, perhaps, unrealistic to assume that the "clear bright line" or "Chinese wall" between bankers and analysts will not be breached. Similarly, in a fast-moving global economy, by the time analysts have done their job and their research has reached the investor, it may be out of date. Indeed, many institutional investors conduct their own investment research, or, with so-called "soft-dollar" arrangements, obtain it at little or no cost in exchange for providing investment firms with their brokerage business; the days of paying high prices for equity analysts are probably over.

Finally, no one seemed to care about conflicts of interest until stock prices began to fall. And since the agreement affects only those with ties to the investment banking world, other investment officials — mutual funds, for example — can continue to hype certain investments and give advice that may or may not be good. This is a special cause for worry, as the mutual fund industry is where most investors have placed their money and faith.

Left unsaid were the contributions of all players — particularly institutional investors, which have chased quarterly earnings like a rabid dog chasing its tail — to the high stakes, high-pressure climate of globalized capital and corporate goliaths. The real problem may not be so much the actions of certain individuals or firms as much as the basic business model they follow, one that emphasizes the authority and power of intermediaries who have forgotten their fiduciary obligation to the investor/owners they are supposed to serve. Even worse are those investors and owners — particularly institutional investors — who have failed to fulfill their fiduciary role as responsible owners, committed to assuring that every aspect of



their investments meet legally prescribed standards of care. One is hard-pressed to see how, as SEC chairman Donaldson asserts, we can “restore investors’ faith and confidence in the fairness and integrity of our markets” if we do not have faith and confidence in the investors themselves.

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### **Power and Accountability: Congress and Regulators React**

In addition to lawyers, state officials, professors, and consultants, Congress and the SEC have been especially busy addressing corporate governance matters. By far the most important is the omnibus law passed over a year ago: On July 30, 2002, Congress passed the Sarbanes-Oxley Act (“Sarbanes-Oxley”), a 78-page piece of antifraud landmark legislation that addressed nearly every aspect of financial reporting. President Bush signed it into on August 1, 2002. Sarbanes-Oxley was a sweeping response to the corporate scandals (and the subsequent loss of wealth on the part of influential congressional constituents) and was aimed squarely at improving corporate accountability and governance.

The goal of the Sarbanes-Oxley Act, as contained in its Preamble, is “to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes.”<sup>40</sup> It is widely viewed as perhaps the strictest legislation affecting capital markets since the Great Depression. It will place demands on corporate boards of directors, forcing them to play a greater oversight role, one for which they were originally intended.<sup>41</sup> Whether it lives up to this expectation remains to be seen: At the end of the day, an ethic of integrity cannot be legislated or regulated, and you cannot always fix things by passing a law.

The passage of the Sarbanes-Oxley Act triggered a series of remedial actions, all aimed at increasing director and auditor independence, corporate accountability, and, by extension, market credibility and the public trust. Most notable is the creation of a new Public Company Accounting Oversight Board (now nicknamed “Peekaboo”), which has been organized to regulate accounting; last April, the SEC appointed William J. McDonough, longtime president of the Federal Reserve of New York, as its first chairman.<sup>42</sup> After an acrimonious debate over who should serve as chairman of this important new oversight body — one that eventually led to the resignation of Harvey Pitt, the SEC’s former chairman — McDonough’s appointment was unanimously endorsed by SEC commissioners, and widely praised by corporate governance experts, business leaders, and public officials. He was formally approved by the SEC on May 21, 2003.

Speaking to participants last March at a session on corporate accountability hosted by the Palm Beach based Coudert Institute, Jeremy Wiesen, a securities law and regulation expert who teaches at the Stern School of Business at New York University, opined, “The [Sarbanes-Oxley] Act is more interesting to read than its parent, the Securities Exchange Act of 1934 (‘the ’34 Act’), because it deals with what people do, not where securities go. The ’34 Act created the Securities and Exchange Commission (‘the SEC’ or ‘the Commission’) and set a framework for the regulation of companies that have gone public pursuant to the Securities Act of 1933 (‘the ’33 Act’). Sarbanes-Oxley is more than just a fine tuning of that legislation — it puts flesh on a seventy year-old skeleton.”<sup>43</sup>

Chief among Sarbanes-Oxley’s provisions is the requirement that publicly traded companies disclose corporate information on a current and continuous basis (called

“Real Time Issuer Disclosures”), thus augmenting the filing of Form 10-Q quarterly reports and Form 10-K annual reports. Previously, the SEC and equity analysts had to rely on corporate press releases for material information. Moreover, since disclosure by itself is not enough unless you also have a review and enforcement mechanism, Sarbanes-Oxley now requires that every issuer have its periodic reports reviewed by the SEC at least once every three years. Other important aspects of the Sarbanes-Oxley Act include the requirements that

- chief executive officers and chief financial officers certify their companies’ annual and quarterly reports;<sup>44</sup>
- lawyers have a whistle-blowing responsibility;<sup>45</sup>
- personal loans to any executive officer or director, with certain exceptions, are prohibited;<sup>46</sup>
- corporate board audit committees be independent (and open to communicating with whistle-blowers);<sup>47</sup>
- a set of internal controls be established and maintained in the form of a “management letter,” certified by the CEO and CFO;<sup>48</sup>
- companies report on whether they have — and if not, why not — a code of ethics for senior financial officers that covers “honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships; full, fair, accurate, timely, and understandable disclosure in the periodic reports required to be filed; and compliance with applicable government rules and regulations;<sup>49</sup>
- corporate reports, particularly in the code of ethics section, be “understandable” and in “plain English”;<sup>50</sup>
- company “pro forma” financial information be consistent with Generally Agreed Accounting Principles (“GAAP”);<sup>51</sup>
- the SEC pass rules, within one year, that will “improve the objectivity of research and provide investors with more useful and reliable information”;<sup>52</sup>
- audit committees “establish procedures for . . . the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters,” including protection for whistle-blowers and penalties against those who would prevent whistle-blowing;<sup>53</sup> and
- the SEC conduct a series of studies, including ones affecting the adoption of a principles-based accounting system, more efficient methods to provide restitution to injured investors, new disclosure rules for off-balance sheet assets, the role and function of credit rating agencies, and a self-study of SEC enforcement actions over the previous five years.<sup>54</sup>

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## Other Corporate Crackdowns

Although it is by far the most comprehensive, the Sarbanes-Oxley Act was not the only reform action in the post-Enron environment. Other state agencies, the stock exchanges, the National Association of Securities Dealers, the Financial Accounting Standards Board (“FASB”), and other regulatory organizations also adopted stricter measures, particularly those promoting greater board “independence” — a slippery notion, to be sure, but usually defined in terms of *organizational status* (that is, one is not an employee of nor does one do business with a company), rather than *qualities of judgment or equity interest in a firm’s operation*. Indeed, “independence” is a state of being, not necessarily a virtue; as noted corporate governance expert Nell Minow puts it, “independent” can mean “indifferent,” and is not necessarily a guarantee of competence or anything else.<sup>55</sup>

Whatever its meaning, the idea of independence is the Holy Grail of corporate governance, and its reality remains just as elusive given the extraordinary number of formal and informal ties among directors, which reduce the likelihood of opposing one’s colleagues. The logical assumption that good corporate governance flows from board independence is a flawed one—good theory, perhaps, but oftentimes untenable in practice. “There’s something utterly anomalous, talking about a participant in a self-perpetuating institution being independent. People are satisfied with the apparent independence of a director, notwithstanding the fact that every single one of them is part of a self-perpetuating process,” says Bob Monks. “One doesn’t have to be a cynic, one only needs to be a bit of a behaviorist and a bit of a psychologist to consider the kind of loyalties that exist among people who are invited to join elite, highly desirable groups.

If you want to create reform in a club, it probably is not the best thing to do to become a member of the club, because there is an implicit if not legal — I would say emotional — undertaking that you agree, as part of the position of joining the group, to work within the culture of the group. And the culture of the group is that you will work out your problems with the group within the group...

[In March 2002] Alan Greenspan gave a speech at NYU’s Stern School of Business. Now Alan Greenspan is not a governance scholar, but is obviously a man of huge prestige and fine intellect. In reviewing the governance landscape, he concluded as follows, *I never met an independent director. There’s no such thing. They’re basically people whose continued existence is at the gift of a CEO, and therefore is in no way independent of a CEO*. He then concluded rather strangely, I thought, that shareholders, whom he considers to be the logical choice to be monitors, choose not to be. Now Greenspan left it at that point, and then went and segued further and came to the only logical conclusion that he could, which was that whether we liked it or not, we were in the hands of a CEO, and we better hope the CEO is benevolent.

Now if a CEO is not only not benevolent, but is toxic... I think Greenspan’s conclusion is wrong, but you have to go back for a minute to his point, which underlies much of the futility of the shareholder movement, and that is that even the most dispassionate learned observer like Alan Greenspan will look at the landscape and will say that shareholders choose not to act as responsible owners, and then moves on as if that’s okay. One doesn’t have to be an ethicist to simply question the appropriateness of someone who has responsibility being in any way allowed by their own determination to undertake not to be accountable for their responsibility.<sup>56</sup>

Nevertheless, the notion of independence continues to reign supreme, providing the illusion of objectivity and good judgment. The New York Stock Exchange, for

example, allocates twelve of its twenty-four board seats to individuals from outside the securities industry; last spring, Madeleine K. Albright, former Secretary of State, accepted nomination to one of these two-year directorships, which was voted by the Big Board's membership in early June. Again, one is hard-pressed to imagine Secretary Albright as an "outsider" of any sort, proving the adage that in corporate governance as well as every other realm, the power of networks and connections reigns supreme, not "independence" by virtue of one's affiliation, expertise, or politics.

Secretary Albright stepped into a situation that already was controversial. The NYSE board vacancy occurred in early 2003, when Martha Stewart stepped down as a result of charges that she had engaged in securities fraud and insider trading; subsequently Citigroup Inc. chairman and CEO Sanford Weill was nominated, which ignited further controversy and heated opposition (particularly from Eliot Spitzer because Weill's company was a target in the regulatory probe) and eventually led to Weill's withdrawal. (On July 16, Weill made the surprise announcement that he was stepping down as chief of Citigroup at the end of 2003, but that he would remain as chairman until the spring of 2006.)

Because of this and other warning bells, on May 15, 2003 the NYSE announced its intention to conduct a review of its own corporate governance procedures, which were to include several days of hearings as well as written commentary from its various constituents. The format of this review process and whether or not it will be open to the public had not been decided when this article was written. But as a first step in that process, on June 5 the NYSE board adopted a revised set of ten governance proposals, which address a number of issues including conflicts of interest and salary disclosure regarding its top officials. Meanwhile, a special board committee will review other governance matters, including board size, composition, and tenure, and whether to split the roles of chairman and chief executive. Leon E. Panetta, the former White House chief of staff who is co-chair of the special committee on corporate governance (former New York state treasurer H. Carl McCall is the other co-chair) described its mission as bringing "the governance of this institution into the 21st century."<sup>57</sup>

The New York Stock Exchange is a self-regulated exchange and a nonprofit corporation owned by its 1,366 members. Nell Minow likens it to a duckbilled platypus because, just as a platypus is a living creature, and is not classified as a mammal or a bird, the NYSE has the force of federal law, yet is not accountable to the financial markets or the political process.<sup>58</sup> Even though it has acted as an advocate for good corporate governance among its members, the exchange's own governance had come under fire for, among other things, its compensation practices and alleged conflicts of interest, with top exchange officials also serving on NYSE-listed companies.<sup>59</sup> Earlier this year, SEC chairman Donaldson asked the Big Board to report on its practices, implying it should practice what it preached; many observers believe the exchange should be held to a higher standard, and serve as a role model of corporate governance.

Back in August 2002, the board of the NYSE adopted a revised set of listing standards aimed at strengthening corporate governance and investor confidence in the more than 2,800 companies that list on the exchange. The newer listing requirements, originally proposed by the NYSE Corporate Accountability and Listing Standards Committee in June 2002, include the following key provisions: corporate boards must be composed of a majority of independent directors, except for those boards where voting power is controlled by a group or individual rather than the

public; nominating, compensation, and audit committees must be composed entirely of independent directors; and companies must seek shareholder approval for stock option plans, with the exception of one-time stock option grants to newly hired executives. The proposed listing rules also require that the independent directors of listed firms meet regularly without management, or insiders, present, and that audit committees meet with auditors without insiders present. The listing requirements are subject to public review and comment; in June 2003, the Securities and Exchange Commission approved those proposals regarding equity compensation, and continues to review other aspects of NYSE's rule changes.

In addition to these NYSE actions, in the summer of 2002 the board of the American Stock Exchange (AMEX) approved a comprehensive array of corporate governance measures intended to form a framework for new rules that would increase disclosure requirements, strengthen audit committee responsibility and board oversight, and enhance shareholder rights. According to published reports, the AMEX governance measures redefine what is meant by "board independence." They also require timely disclosure of board changes and vacancies; prohibit any AMEX employee or floor member from serving on the board of an AMEX-listed company; that audit committees be chaired by an individual with substantial financial experience; that audit committees approve all related party transactions; that shareholders approve all stock option plans; that AMEX-listed firms hold at least quarterly board and audit committee meetings; and that listed companies adopt a code of ethics and implement a compliance program.<sup>60</sup> In July 2003, AMEX filed its proposed listing rule changes with the SEC, which will be reviewed, possibly modified, and then issued for public comment.

Not to be outdone, in July 2002 the Nasdaq Stock Market's board of directors approved more than twenty-five new corporate governance reform proposals aimed at increasing the transparency and accountability of firms listed on the exchange. The Nasdaq proposals had four major objectives: increase board independence by requiring a majority of board member be outsiders; strengthen the role of independent directors in compensation and nominating committees; mandate continuing educations for directors; and mandate the acceleration of disclosure of transactions by corporate insiders. On March 17, 2003, the SEC published these proposed Nasdaq rule changes for public comment. In June 2003, The Corporate Library reported that the SEC was attempting to reconcile the proposed NYSE and Nasdaq rule changes with regard to director independence.

In an interview held late last year, Richard F. Syron, chairman and chief executive officer of Thermo Electron Corporation, was asked for his thoughts about the flurry of reform in a post-Enron environment. When Syron speaks, people listen, as his illustrious career attests. Holding a Ph.D. in economics from Tufts University, Syron also has experience both as a regulator and business manager, with stints as president of the Federal Reserve Bank of Boston and the American Stock Exchange before joining Thermo Electron in 1999.

While at the Fed, Syron was a high-profile leader who was unafraid to speak his mind on such controversial issues as the impact of race on lending practices and the wave of banking failures that swept the nation in the early 1990s; he is credited with helping to keep many New England banks solvent. During his five-year tenure at AMEX, Syron was responsible for finding new securities listings for trade, as well as the merger of the exchange with the National Association of Securities Dealers, the Nasdaq parent. At Thermo Electron, which is based in Waltham, Massachusetts, he successfully has overseen a massive company-wide restructuring

featuring higher degrees of transparency and synergy. Equally at ease in the worlds of theory or practice (and able to connect the two), Dick Syron gracefully displays the civic stewardship qualities advanced in this article.

What, he is asked, is the remedy for corporate corruption and governance failures? “You can do all the regulations in the world you want, and some of them will have some beneficial effect, but there are two things,” he said. “One is, crooks are going to find ways to do crooked things, no matter what [regulations] you write. The other is, you have to get investors and everyone else to have a longer-term view of things. You put all that together, and you’ve got a recipe that doesn’t work very well...

The first issue we’ve got to address is, over what time frame are we trying to get people to focus? We talk about the stock market — but there isn’t one stock market. You have traders, you have investors, you have long-term holders, you have churners, and so on. It’s easy to say, and it’s not advice that I always follow myself, but you have to learn to ignore the short-term noise. Easy to say, hard to do, but wisdom comes with time...

The primary reason why the Federal Reserve was set up was to take into consideration that there are some things that you take actions on that won’t be immediately popular, but that are the right things to do in the longer run. And you know, the same challenge applies to companies and the [investment] funds.<sup>61</sup>

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### **Where Are We Now?**

So what do these various proposals, laws, and rules changes mean for restoring investor confidence and improving board composition and competence? And what lasting imprint have they left on our federal system of checks and balances?

The answers to these questions are hard to give, because there is so little information about compliance; a major problem here is the fact that with respect to the Sarbanes-Oxley Act, major parts of the bill’s 68 sections are not even in effect yet, making thorough evaluation of its impact impossible. By its first anniversary, noncompliance with its provisions, which was supposed to result in hefty fines or even jail time, could not be determined because there is no central clearinghouse of information. It takes time to digest the new rules, assemble qualified staff, and begin the process of implementation; the SEC, public companies, and legions of lawyers, accounting firms, insurance companies, and other consultants have scrambled to do so as they also seek clarification of what compliance really means. Most observers believe that it will take several years before a final verdict can be reached as to what works and what does not.

One year after the passage of Sarbanes-Oxley, much survey evidence suggests that corporate executives are beginning to suffer from “governance fatigue” as they implement the law’s provisions, remain divided as to whether or not the law has helped to boost investor competence, and continue to experience corporate governance problems. There continues to be a good deal of executive grumbling about the Act’s scale and scope. In March of this year, a study by PricewaterhouseCoopers stated that roughly 85 percent of corporate boards and management have begun the process of revising their governance and operating standards and procedures, usually including provisions for more independent directors. But only 9 percent of executives considered Sarbanes-Oxley an effective antidote to corporate malfeasance, with 42 percent claiming that compliance will impose unnecessary costs, and

82 percent expressing confidence that their firms were already in compliance with the Act's principles.<sup>62</sup>

The good news / bad news message of these corporate executives contradicts the findings of the IRRC. The annual IRRC survey of the Standard & Poor's Super Composite 1500 revealed that while the top 1,500 companies listed on the NYSE may be working hard to meet new corporate governance requirements proposed by the NYSE and other stock exchanges, many companies still have a long way to go. Only 51 percent of the companies have formed governance committees, and a mere 13 percent currently meet the NYSE requirement that corporate boards have a majority independent directors. Twenty-nine percent of audit committees, 25 percent of compensation committees and 48 percent of nominating committees at the firms surveyed still fail the NYSE's independence test.<sup>63</sup>

Notwithstanding these claims and counterclaims, many boards have engaged in special training programs — which have sprung up everywhere — or sent their members to those that are springing up throughout the nation's business and law schools to help them hone their director skills. Boards also have struggled to define the qualities and characteristics a "good" board member should have. But not everyone on the company side is happy with the newer demands on board performance, and the fines and penalties that await those who fail to perform well. Already, insiders have noticed a recent tendency of some board members to move off of boards, primarily due to liability concerns.<sup>64</sup>

How board members are nominated and selected will be the acid test of many of these reforms; as it stands, the process is still heavily rooted in informal buddy networks and CEO preference, rather than one that — as in organized politics — draws candidates from the voter population, asks them to state their views or platform, and fields them in a series of primaries or slates. Recent SEC proposals and changes to the New York Stock Exchange listing standards have helped somewhat; corporate board nominating committees are now required to be composed of outside independent directors to assure transparency and accountability. The next step — one not yet taken — will be to have institutional investors serve on these nominating committees to help assure less of a rarefied board atmosphere and better shareholder representation.

Meanwhile, a study released in November 2002 by the Washington-based Investor Responsibility Research Center ("IRRC"), an authoritative source of corporate responsibility information, found that 70 percent of S&P 500 companies and 66 percent of New York Stock Exchange-listed firms will have to make changes to their boards to meet pending requirements for director independence. Only 74 percent of S&P 1500 companies have nominating committees, and only half of those are independent. Almost all S&P 1500 companies have compensation and audit committees, but only 73 percent of audit committees and 71 percent of compensation committees could be considered independent.<sup>65</sup>

As for federalism, the backlash regarding state's rights and federal power has already begun. After all, it was a state attorney general who went after Wall Street, not the SEC. Even though they ended up working closely together, there are a lot of hurt feelings and lingering resentments that the states had pre-empted what the Federal government was supposed to do. In late spring of 2003, congressional Republicans attempted to curtail the power of state regulators and boost the ability of the SEC to collect penalties for securities fraud and direct them to victims of securities violations. These proposals, contained in a bill before the House Financial Services Committee, were loudly rebuked by Eliot Spitzer — widely believed to be

their target for his zealous prosecution of offenders — and ignited a firestorm of opposition from those who claimed that the SEC was kowtowing to Wall Street and Capitol Hill. On July 24th, the House committee pulled the measure after some SEC officials privately told House Republicans that this was not an auspicious time to call a vote; it was postponed until September 2003.<sup>66</sup>

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### **See How They Run**

For many years I have argued that we will see the day when elections for boards of directors, corporate and institutional investor alike, will resemble that which we have in public life, replete with nominating conventions, some version of political parties or affinity groups, platforms and planks, electoral campaigns, debates, and the other trappings of democratic self-governance — perhaps even political consultants. (Move over, James Carville.)

A precedent for this was Bob Monks's 1991 campaign for a seat on the Sears, Roebuck board of directors, a move that sent shockwaves through the then-nascent shareholder activism movement. Moreover, I predict we will see much more activism directed to entire industries, similar to current efforts being waged on by groups such as CERES and the Global Reporting Initiative on environmental matters.<sup>67</sup> Up next will be more vigorous investor pressures on the pharmaceutical and drug industries as well as the media and entertainment industries to produce better quality products and adhere to agreed-upon standards and practices aimed at positive financial and ethical performance; the work of Carol Atwood and Spartacus Media Enterprises, sponsor of "Investing in Media that Matters," a conference held this past January at Sundance Village, is headed in this direction.<sup>68</sup>

The signs of more robust corporate board elections already have started to appear, particularly involving union pension funds that are seeking better representation. Depending upon the final outcomes of the SEC's proposed rule changes on shareholder access to board nomination and election, board elections will become even more interesting. But considering the state of modern electoral politics, which has become divisive and dominated by big money and special interests, whether this is a good thing remains to be seen.

On the professional service side, accounting firms have revised their operations, while law firms and financial advisors have made adjustments in how they advise their clients. Academic institutions have rolled out special training programs. Amid all of this, not surprisingly, a flurry of consultant firms have opened up shop, issued studies and press releases, and identified areas for improvement — improvements they consider themselves best suited to make. And insurance companies are reaping huge financial benefits, as the cost of liability insurance for board members has risen dramatically, with shareholder claims totaling billions of dollars.<sup>69</sup>

Nevertheless, as with the measures affecting tighter controls on securities firms, left undone are mechanisms for assuring that investors are doing their job, or are making good decisions. We still do not have a "fiduciary creed", or a working model of "good fiduciary governance," beyond the elastic assumptions of fiduciary law. Corporate oversight without attentive, informed, and engaged investors is like political oversight without attentive, informed, and engaged voters: You cannot expect good governance from the former when most of the latter have abdicated their responsibilities, stayed home, and watched TV.

The time has come to move forward with a new kind of "voter education project," in the sense of where institutional investors are able to understand and act



upon the fundamentals of good governance, as some companies are doing. As with the League of Women Voters or the civil rights movement, this means educating shareowners about the franchise they possess, and encouraging them to use it. But more than voting, it means shareholders understand their rights and responsibilities as owners, who are now in a position to improve the governance and operation of the companies and industries in which they hold stakes.

In procedural terms, this involves greater levels of transparency, accountability, participation, and representation, so that shareowner interests and values are truly fulfilled. In substantive terms, it also involves greater grounding in those civic virtues — including honesty, integrity, fairness, justice, and reciprocal obligation — that reinforce an ethic of trust and healthy community. Overall, it means that institutional investors articulate policies and practices that embed the principles of good governance into their mode of doing business, thereby increasing levels of participation, accountability, and representation regarding those beneficiaries who are the ultimate bearers of economic risk. It means they pledge themselves to a standard of good fiduciary governance that mirrors the same framework of expectations they apply to corporations.

Doing this would place investors in a better position to monitor not just corporate but their own performance, thus contributing to wiser stewardship on the part of investor governing boards that, in theory, represent the long-term interests of beneficiaries, whoever they might be. Doing this means we will need new structures, new forms of education and training, new role descriptions, and new resources to assure that owner and investors have the necessary knowledge and expertise to perform their tasks well. The reason this is so important is that the problem of market credibility and corporate governance is also a problem of fiduciary failure on the part of owners and investors, as well as the other legal and regulatory power failures that have been identified.

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**Guardians of the Public Interest:  
The Role of Trustees and Directors in  
Preserving Equity Culture and  
Restoring Good Fiduciary Governance**

Your representative owes you, not his industry only, but his judgment; and he betrays instead of serving you if he sacrifices it to your opinion.

— Edmund Burke  
*Speech to the Electors of Bristol, 1774*

Boston is a privileged area because of its history and values, its institutions, its culture, and its people. The birthplace of civil society, its New England roots are deeply planted in an ethic of caring and fairness, inspiring a model of governance that did not distinguish between public and private realms, a model that was to serve as the basis for democratic structures to come. The 1629 chartering of the Massachusetts Bay Corporation, followed soon thereafter by the incorporation of congregational churches and local townships, and later by Harvard College, set the stage for the virtues of representative lay governance, with moral commitments and the competitive spirit of innovation serving as the propellant for reaching community goals.

While this model has evolved and changed over time, subject to the prevailing passions and prejudices of the culture, the guiding principle of colonial life remains intact: self-governance is a means through which a free people remain free, subject to rules and conditions that derive from voluntary agreements and obedience to man-made and nature's law, one's conscience, and God.

We need to remind ourselves that at the beginning of American society, with religious faith and Enlightenment theories as a backdrop, property ownership and the marketplace were subordinate to civic virtue, and civic virtue was enshrined in our laws and institutions, including notions of trusteeship. Property ownership, as envisioned by the Framers in their design of our federal system of checks and balances, was a ticket to democratic political participation, even though politics was not the only influence on the evolving economic life of the Republic. Religious faith and interpretation served as a subtext for how we organized our economic arrangements, and for how commerce and capitalism, particularly the emergence of the modern business corporation, came into being. Moral virtue was tied to good stewardship and the acquisition of wealth, a union sometimes at odds with the spirit of democracy (citizens without property were excluded from the business of governing, not unlike modern times wherein big money dominates the electoral process), yet driving continued public suspicion of any concentration of wealth and power.

Since John Winthrop's 1630 call for a covenantal city on a hill and the hegemony of Yankee Protestantism (particularly Puritanism and Quakerism), the relationship between money and morality lie at the heart of two themes that continue to endure in American public life: the role of piety and faith in building and sustaining community, and the influence of competition, individualism, and self-interest in doing so. While Winthrop emphasized the predominance of faith, family, and community in realizing the American dream, this civic moral framework later gave way to the emerging capitalist order and, by the early 20th century, receded in importance as capitalists and economists, taking a cue from their 18th century secular brethren, began to utilize scientific principles in measuring and managing economic performance.

For three hundred years, the notion of money and morality was not an oxymoron; to the contrary, it was considered an article of faith in American culture, however tense that relationship might be. At the present time, the tension between private ownership (meaning corporate equity, evoking the equites of antiquarian Roman society) and the public interest continues, with trustees and directors serving as the first line of defense. Cultivating and enacting responsible ownership and fiduciary governance affects not just the manner in which financial assets are managed but speaks to the very core of what it means to be a trustee or director.

The primary assumptions governing the role of trusteeship and directorship became neutered within the past 100 years as a result of the rise of the modern bureaucratic state and the corporate form, the ascension of scientific management, and the professionalization and technological transformation of financial services. Yet being a trustee carries with it representative responsibilities to "the other" or "others," so the threshold question becomes, which "others" are we talking about, and whose interests are being protected and advanced?

Put another way, are trust beneficiaries to be viewed as economic units alone, with little interest in anything other than the size of a dividend check or a payout? Or might they also be viewed in more human terms, as individuals with lives to

lead much as trustees themselves do, who breathe the same air, are vulnerable to illness and disease, to the same eruptions in the earth's ecosystem or social systems?

Much like trustees and directors, are not beneficiaries also dependent upon a civil order that is literate, safe, and respectful of human dignity and creativity? Indeed, might not these very same beneficiaries be qualified to vote? Are they not — as are we — citizens, too? Do they watch television, surf the Internet, read books and newspapers, listen to music, or admire (perhaps even create?) works of art? Do they seek to learn, or (to use that hackneyed phrase), develop their full potential, not just in childhood or adolescence, but throughout their lives?

What we are talking about here are whole human persons, with needs and wants, aspirations and dreams. Just as a civic stewardship ethic looks at investment performance not only empirically but in normative terms as well, restricting itself not just to financial performance but also addressing ethical and social matters, so, too, does it call for a trustee role that sees beneficiaries *and shareholders* as something more than economic units. They are human persons living as best they can in a natural world, possessing frailties and vulnerabilities that trusteeship is intended to protect. Whatever the terminology — trustee, director, custodian, guardian, or curator — its essence remains the same: one is acting in the interests of someone else, and that “someone” and “those interests” simply cannot be reduced to coins and paper. At the end of the day, there is little qualitative difference between the human concerns of trustees and directors and the human concerns of those they are supposed to serve and protect.

The fiduciary challenge, then, for trustees and directors (similar to that confronting judges) is to make public decisions that fulfill both the immediate obligations contained in a charter or mission statement, and the broader public interest obligations attendant to human health and well-being. Doing this well involves both a grounding in the particularity of privately-held core beliefs and commitments (call it “character”), and a broader conception of what we share in the public square, a place where common rules and common understanding, supported by situational ethics, legal precedents, and the political art of compromise, come into play.

Trustees and directors are not thermometers, reflecting the temperature of prevailing opinion. Nor are they bodyguards, whose aim only is “to preserve and protect.” The aim of trusteeship — indeed, of being *trustworthy* — is to preserve the health and long-term interests of those being served, but also to shape and transform the world in the name of the good. In other words, all trustees are citizens with a bigger brief, even if not all citizens are trustees. By extension, all shareholders are citizens, too, even if not all citizens are shareholders.

In *A History of Nonprofit Boards in the United States*, historian Peter Dobkin Hall of Harvard's Kennedy School of Government points out that original notions of trusteeship, whether public or private, reflected substantial civic commitments, so much so that there was no distinction between public and private domains. Current corporate and nonprofit governance is rooted in practices dating back to the nation's founding; the charter creating the Massachusetts Bay Company, which created the first American board, “made the rights and privileges of the private [land] grant equivalent to those of the state.” In addition to the idea of “perpetual succession” (the right of corporate members to appoint their successors and elect officers), the fundamentals of trusteeship, in American terms, reflected what was to become the foundation of democratic civil society in years to come.

Although these democratic structural features were constrained by “powerful informal norms of deference” to citizens who were more wealthy, white, male, and

educated than anyone else, the idea of self-governance, with an elect group entrusted with the responsibility for balancing individual and collective interest, came to characterize two of the pillars of public life. Hall tells us that “like property rights, the roles and responsibilities of boards of directors and the organizations with which they are associated — as well as the broader legal, governmental, and economic settings in which they operate — have evolved and changed over time.” Yet throughout the development of philanthropic and voluntary associations, our constitutional government, and the business firm, one thing has remained constant: All can be interpreted as public enterprises that are engaged in public service, to the extent that they derive their legitimacy from the governed, and because, “values and convictions — a sense of stewardship — [are] central to any and all.”

Indeed, whatever the organization might be, it exists in and draws sustenance from the complex web of modern life. Boards, and board members, thus become “‘boundary-spanners’ for whom board service joins private and public values . . . [exercising] unique dual roles as managers of the internal cultures and the external environments of the entities they serve and, as such, are strategically situated to have a broadly powerful transformative influence on the world of which they are a part.”<sup>70</sup>

In our pluralist society, there is no predominant model of trusteeship beyond its broad policy setting and oversight role. At the CERES annual conference held this past April, Holly J. Gregory, one of the nation’s leading experts on board behavior and corporate governance, and a partner at New York’s Weil, Gotshal & Manges LLP, talked about the fact that directors’ legal mandate is broad and vague, leaving a great deal of discretion for interpretation. In order to act prudently and in the corporation’s best interests, directors need to exhibit good faith, a degree of care, and the qualities of “an ordinarily prudent person in a like position, under similar circumstances.” Directors should “reasonably believe” that their actions are in the best interests of the corporation as they go about the process of selecting, monitoring, evaluating, compensating, and, when necessary, replacing senior management; reviewing and approving strategic and long-term plans (which involves understanding risks); monitoring corporate performance against these plans; reviewing and approving material capital allocations, financial standards, and policies; ensuring financial control and reporting / disclosure integrity, ethical standards, and legal compliance; monitoring constituent relations; and organizing the board.

Gregory’s remarks included a thumbnail sketch of the newly released *Report of the Blue Ribbon Commission on Risk Oversight: Board Lessons for Turbulent Times*, produced by the National Association of Corporate Directors.<sup>71</sup> The report outlined the fiduciary responsibilities directors have for overseeing adequate risk management, which can help prevent future corporate scandals. A prerequisite is a corporate governance framework enabling informed and sound judgments. Other requirements include understanding the specific risks facing organizations board members serve, and ensuring that there is a process in place to alert them to the occurrence of those risks. Boards should ensure that management has identified the specific material risks the company faces, including short-term and long-term risks, as well as intrinsic and extrinsic risks. Directors “should be ‘risk-minded’ as they review [organizational] reporting, operations, and compliance,” while being “sensitive to the impact that specific risks may have on each group of stakeholders, including employees, customers, suppliers, and local community groups.” Moreover, boards should ensure that continual reevaluation of risk management practices

occurs, and that “processes are in place to comply fully with relevant laws and regulations.”<sup>72</sup>

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### **Power and Accountability: Institutional Investors React**

In modern society the basic mechanisms of justice are becoming more and more economic rather than political, in the sense that economic power is the most basic power. Political power is derived from it to such a degree that a just political order is not possible without the reconstruction of the economic order. Specifically this means the reconstruction of the property system. . . .

The fact is that democratic principles and traditions are an important check upon the economic oligarchy, even though the money power is usually able to bend democracy to its uses. The proof that this democratic restraint is still vital is given by the effort of the economic power to abrogate democracy when the latter imperils the rule of the financial oligarchs.

— Reinhold Niebuhr  
*An Interpretation of Christian Ethics*, 1935

In a significant regulatory decision that invigorates equity culture, earlier this year the Securities and Exchange Commission determined that the shareholder suffrage, the power to vote proxy resolutions, was both a public matter of corporate governance and a fiduciary duty of corporate monitoring. Consistent with the transparency mandate of Sarbanes-Oxley, which delegated broad rulemaking authority to the SEC, on January 23, 2003 the SEC, after a heated process of public review, voted 4-1 to adopt new rules for mutual funds.

The new SEC rules — “Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies” and “Proxy Voting by Investment Advisers” — require mutual funds and investment advisers to reveal their guidelines and procedures for proxy voting, as well as the actual voting records. Taking effect in July 2003, the proxy disclosure requirements affect an industry representing some 95 million Americans who invest in mutual funds, directly or as an option in their 401(k) or other employer-provided retirement plan. The combined assets of the roughly 3,700 mutual funds now on the market represent \$6.5 trillion, accounting for roughly 21 percent of ownership in American companies.<sup>73</sup>

In 1999 the \$130 billion California Public Employees’ Retirement System (“CalPERS”) was the first pension fund and the \$1.3 billion Domini Social Investments (with proxy voting guideline assistance provided by KLD Research & Analytics, Inc., a Boston-based corporate social research firm) the first mutual fund to disclose its proxy voting policy and voting records. Along with the AFL-CIO and Teamsters, Domini Social Investments played an instrumental role in launching a chain of events leading to SEC adoption of proxy disclosure rules, which continue to remain contentious. On November 21, 2001, Amy Domini wrote a letter to SEC chairman Pitt urging proxy disclosure, following similar appeals by the Teamsters earlier that year and the AFL-CIO in late 2000; these actions were accompanied by a massive letter-writing and email campaign resulting in thousands of messages sent to SEC officials.<sup>74</sup> Meanwhile, last March, two months after the SEC proxy disclosure decision, the AFL-CIO and other labor unions urged mutual funds to

disclose how they vote on corporate proxies this year, rather than wait for SEC rules to take effect in 2004.

The proposed proxy disclosure rules invited vigorous opposition from the mutual fund industry, led by the Investment Company Institute's emissaries Edward "Ned" C. Johnson III, Fidelity Investments chief executive, and John Brennan, Vanguard Group chief, who asserted that requiring mutual fund managers to disclose their votes on corporate proxies would politicize proxy voting. (Fidelity and Vanguard are the two largest mutual fund companies in the world, with respective assets of more than \$799 and \$575 billion under management.) A prominent dissenter to this wall of resistance was John C. Bogle, Vanguard's founder and former CEO, who agreed with the SEC's proposed rules.

"A fund manager's focus belongs on investment management, not on becoming an arbiter of political and social disputes," Johnson and Brennan argued in a *Wall Street Journal* op ed piece, and continued by offering an alternative that locates voting and monitoring authority more centrally, in the hands of mutual fund boards. "Instead of all the regulation, why not simply enhance the proxy oversight role of mutual fund boards? Ensure that they hold their companies to clearly established proxy voting guidelines. Let them see that fund managers' votes are consistent with the company's guidelines — subject to SEC examination."<sup>75</sup>

Another major institutional investor opposing the proxy disclosure measure was the \$262 billion Teachers Insurance and Annuity Association College Retirement Equity Fund ("TIAA-CREF"), on the grounds that public reporting would expose certain shareholders to "undue pressure" from corporate management.<sup>76</sup>

What these critics failed to acknowledge is the extent to which the investment process has already become politicized, responding to the special interests of business and trade groups, corporate insiders, and — in a highly concentrated ownership universe — large institutional investors and money managers. Shareholder activism is but one in a broad array of forces influencing corporate decision-making. Meanwhile, Brennan and Johnson's proposal to expand proxy oversight responsibilities of a mutual fund's board fails to address the widespread current concerns about transparency, and fails to acknowledge the reality that the governance of mutual fund boards remains a "black box" for investors, with little or no accountability to fund participants. The absence of a prevailing theory or framework, ethic, and vocabulary on responsible ownership and fiduciary governance, as well as models, standards, and practices begs the question of full disclosure and is the animating force of this article.

The disclosure critics also consider social and political concerns as distinct from financial ones; this is a spurious claim, given the interrelationships between normative and empirical considerations, as has been demonstrated repeatedly. Indeed, for several decades investors, business managers, accountants, and academic researchers have developed various models for measuring the performance of tangible and intangible assets, including human and social capital. Whatever the terminology — corporate social responsibility, reputation analysis, ethical investing, social auditing, sustainable governance, triple-bottom-line, social venture capital, and so on — the objective is the same: to assure prudent performance of financial assets in accordance with solid principles of fiduciary duty and democratic pluralism.<sup>77</sup>

Finally, critics argue that the increased paperwork burdens and costs will harm mutual fund shareholders, another spurious claim given the availability of electronic and Internet technology and the high fees and compensation packages paid to managers. Moreover, under the provisions of the Employee Retirement

Income Security Act (“ERISA”), corporate pension funds have been under the same obligation. Thanks both to Bob Monks’s leadership as assistant Secretary of Labor, who opined that proxy voting was a tangible asset with beneficial value, and a 1988 decision by the Department of Labor — the so-called “Avon letter” — stating that proxy voting is a fiduciary duty, ERISA funds have been required to vote their proxies in the best interests of beneficiaries.<sup>78</sup> They do not seem to have suffered.

On December 14, 2002, John Bogle publicly admonished his colleagues in the mutual fund industry and called upon them to become more active in corporate governance, given traditional principles of trusteeship and their prominence in the corporate equity ownership universe. “The time has long since come for funds to cease their passivity as corporate owners and to assume the important responsibilities of corporate citizenship,” he wrote in a statement appearing in the *New York Times*. Careful to say that while he no longer serves as an officer or director of the Vanguard Group, “my views reflect the principles and values that I tried to make manifest in the creation of Vanguard...

Mutual fund directors, officers, and managers are the agents; the fund shareholders are the principals. It is management’s responsibility to act solely on their behalf. It would thus seem self-evident that each mutual fund shareholder has the right to know how the shares of the corporations in his or her portfolio are voted...

When funds are required to report their votes, some business difficulties may arise. Votes against management, for example, may make it harder for fund managers to get information from a corporation or to win the right to advise its pension plan. Controversial votes may draw unwanted publicity. Yet I am skeptical of other industry claims. While fund managers claim disclosure would be too expensive, it would be trivial compared to the \$75 billion that shareholders paid for fund management last year. Other managers claim it is more effective to work ‘behind the scenes’ with corporate management. If so, let them present a record number of contacts made with managements and the issues discussed. Without these details, such statements lack credibility.<sup>79</sup>

This past July in the *Wall Street Journal* Bogle continued to speak out on the need for the mutual fund industry to live up to its obligations, as laid out in the Investment Company Act of 1940, to put the national public interest and the interests of shareholders ahead of everyone else. The impetus for Bogle’s message was Congressional legislation that would strengthen the independence of mutual fund boards of directors from fund managers and require the disclosure of administrative costs to mutual fund investors. Under consideration is a bill that would increase the number of independent fund directors to two-thirds of the board, with an independent director as board chairman; also pending is legislation that would require quarterly reporting on costs that shareholders incur relative to fund expenses, as well as the cost of portfolio turnover relative to the fund’s assets. Such measures, Bogle argued, would serve to increase investor earnings by reducing both conflicts of interests and fund expense ratios (which reached an all-time high of 1.6% of equity fund assets in 2002).

But the larger problem, he says, is that the industry has lost its moorings. “Originally rooted in a focus on stewardship, the fund industry has gradually come to focus instead on salesmanship,” Bogle wrote in his *WSJ* commentary. “[T]he fund industry has not adequately measured up to its statutory responsibilities of stewardship to mutual fund investors.” He went on to propose an amendment to the 1940 Act that would establish a standard of fiduciary duty on the part of all fund directors “to place the interests of fund shareholders ahead of the interests of fund

managers and underwriters.” Yet in the long run, Bogle said, laws and regulations can go only so far to restore the primacy of the public and investor interests; needed is a “change of heart” motivated not by Congressional action but by “our own enlightened self-interest.”<sup>80</sup>

Throughout the spring, public criticism of the labor costs involved with administering the SEC’s new rules continued, and contributed to the SEC announcement on April 14, 2003 that it would revisit its rules on shareholder proposals. At stake are not just the particulars of SEC regulations governing proxy resolutions, but the extent to which it wants to continue to devote limited regulatory resources, “acting as referees in the shareholder proposal process,” SEC Commissioner Paul S. Atkins, a Republican, said in an address last March to the Council of Institutional Investors (“CII”).<sup>81</sup> The Commission directed its Division of Corporation Finance to conduct a review of “possible changes in the proxy rules and regulations and their interpretations regarding procedures for the election of corporate directors,” a review encompassing not only director elections but also an examination and consultation process “to examine current proxy regulations and develop possible changes to those regulations to improve corporate democracy.”<sup>82</sup> In July, the Division submitted its report, *Review of the Proxy Process Regarding the Nomination and Election of Directors*, which was released by the SEC to the general public.

When announcing the January SEC decision mandating mutual fund proxy disclosure, outgoing SEC chairman Harvey Pitt made specific mention of the pioneering efforts of Bob Monks and Nell Minow who, fifteen years ago, inspired a letter to the SEC seeking fuller proxy disclosure on the part of mutual funds and institutional investors; he also cited the letters and e-mail messages urging adoption received from more than 7,000 investors, both individual and institution. Over recent years, the AFL-CIO and Teamsters pension funds as well as Domini Social Investments led the proxy disclosure campaign, which involved numerous parties from the socially responsible investing (“SRI”) community.<sup>83</sup>

In addition to proxy voting, the SEC also has revised rules governing shareholder reports, including the provision that mutual funds provide quarterly filings on portfolio holdings. With regard to pension security, Congress is considering amendments to ERISA, with an eye toward fixing “outdated federal laws” and providing “key safeguards to protect the interests of the workers and investors.”

Meanwhile, the House and Senate have addressed the issue of mutual fund fees, costs, and operations. The Mutual Fund Integrity and Fee Transparency Act of 2003 is currently in the Senate. This past July, the House Financial Services Committee approved a bill requiring greater disclosure of mutual fund fees and placing limits on fund manager conflicts of interests; the bill now goes to the House floor.

Not to be trampled by an angry Congress, the mutual fund industry has rallied to offset tougher legislative efforts by lobbying the SEC to adopt certain “best practices” contained in proposed legislation.<sup>84</sup>

Not all good governance bases are covered, however, by the new or proposed legislation. A major issue not addressed by Sarbanes-Oxley concerns executive pay and stock options; a rule submitted in October 2002 to the SEC giving shareholders veto power over corporate stock option plans was finally approved, even as the SEC scrambles to put compliance standards and procedures in place.<sup>85</sup> Meanwhile, as stock prices have plummeted, companies continue to hand out hefty compensation and stock option packages to their executives.<sup>86</sup> Microsoft’s mid-summer action to drop the use of options is widely expected to have a ripple effect, though, so time will tell.



What began as a reform agenda pushed by a handful of dissidents 20 years ago has evolved into widespread intergovernmental wrangling affecting the judicial, executive, and legislative branches. The question of “good governance,” however it is answered, ultimately relies on the machinery of our constitutional system of representative governance, and the separation of powers envisioned by the Founding Fathers.

In the realm of corporate power, the land of the greedy guilty and the mighty fallen, the whirlwind of reform could very well be much ado about little. We will need to take a wait-and-see approach regarding the implications of the Wall Street enforcement action and the implementation of Sarbanes-Oxley provisions; behavioral change does not happen overnight, particularly where money and power are concerned.

Most of the changes in the listing rules used by U.S. stock exchanges now under consideration by the Securities and Exchange Commission will probably have a more enduring impact on corporate reporting and accountability than the regulatory moves, but these still are not enough to assure better markets and restoration of a climate of trust in equity culture.

These are not enough, because the war on greed, like the war on terrorism, is asymmetrical: all it takes is a few predators to throw things out of whack. Government action is not the final answer. The actions of the accounting profession, Wall Street analysts, corporate lawyers, banking institutions, business schools, and the media deserve further scrutiny, too, and, where necessary, correction.

But these are not enough to stem the tide of wrongdoing and restore the public trust.

We also need to consider the broader question of what it means to own property, and how both private prosperity and the public interest can be accommodated. We need to cultivate an ethic of capitalism tied to the values of self-governance and the virtues of human community. We need more common sense and civic virtue so that good fiduciary governance can take root and flourish.

We can begin to do this by capitalizing — literally and figuratively — on the civic and ownership power we already have. How so? This article has argued for broadening the movement for shareholder responsibility, addressing the governance regimes of institutional investors, and strengthening their capacity to develop and discharge responsible ownership policies. In addition to the path breaking work of large institutional investors, some impressive movement also has been pioneered by a handful of smaller ones, including The Boston Foundation and the New York-based Nathan Cummings Foundation, which is described later.

More recently, the International Corporate Governance Network (“ICGN”), a worldwide association of institutional investors that is based in London, issued a Statement on Institutional Shareholder Responsibilities. Having already passed through a process of public review, on May 22, 2003 the ICGN unveiled the final text of its Statement on Shareholder Responsibilities, which was ratified by members at the annual ICGN meeting, held July 11, 2003 in Amsterdam. The ICGN intends to follow up its proposed shareholder responsibility coda with two other separate documents, one on principles regarding shareholder rights, and one on global standards for fiduciary trustee independence and competence. Continuing his commitment to public education, Robert A.G. Monks is a member of the six-person ICGN Committee on Shareholder Rights and Responsibilities and was instrumental in writing the proposed outline.

Charged with defining best practices for corporate governance, the ICGN Statement addresses the fact that “institutional shareholders as a class have an equal responsibility to address their own roles as fiduciaries and owners of equity on behalf of savers.” The Statement sets out a framework of best practices on the implementation of fiduciary responsibilities with respect to equity ownership, and is directed to institutional investors and their agents throughout the world. It is careful to proclaim that these responsibilities are described in general terms, “addresses the entirety of those relations, not just the shareholder’s responsibility to vote shares,” and cautions that they should be considered with a pragmatic eye. “Different legal systems, different contractual relations, and different markets will require different approaches,” the Statement reads.

It needs to be stressed that this Statement considers governance and investor responsibilities associated with it not ends in themselves, but means to achievement of optimum interests of beneficiaries. It should not be taken to encourage any form of rote compliance with excessively detailed guidelines that might inhibit the ability to make decisions on the merits.

It called on funds to allocate resources to corporate governance monitoring, disclose how they exercise ownership responsibilities such as (but not restricted to) share voting, and manage conflicts of interest to ensure that the interests of beneficiaries come first. So far, the ICGN initiative represents the first time an organization representing investors around the world has articulated performance benchmarks on shareholder accountability. “The ICGN Board believes that this Statement can lend strength to investor stances on the governance of companies; gird investor confidence in the ability of funds to represent shareowner interests; and contribute to the integrity of global capital markets,” reads the Introduction to the Draft Statement.<sup>87</sup> By issuing a treatise on fiduciary governance, there is little doubt that ICGN has set an important precedent for American civic, business, and political leaders to follow.

Closer to home here in Massachusetts, that leadership already is on display. For the past several years, Representative J. James Marzilli has worked hard to strengthen the fiduciary role and operation of the Pension Reserves Investment Management (“PRIM”) Board, which oversees the Commonwealth’s retirement system and \$28 billion pension funds. Rep. Marzilli’s primary focus has been on transparency and accountability to economically relevant social and environmental standards. In addition to his work on legislation and government improvement, for the past several years Rep. Marzilli has convened a working group of concerned investors and citizens to address the question of good fiduciary governance, particularly with respect to proxy voting and the integration of social and environmental criteria. The group has been meeting regularly for several years, and includes a number of prominent investment and intellectual practitioners (including this author) who have offered to work *pro bono* with the PRIM Board and Treasurer’s office to improve efficiencies and performance.

Although the Massachusetts pension funds deserve high marks for having developed a detailed set of proxy voting guidelines with respect to corporate governance, and have begun to conscientiously vote proxies, there are still a number of challenges that lie ahead. Foremost is proxy disclosure, in keeping with the requirements of the SEC, affecting mutual funds and investment advisers and ERISA, affecting private company funds. Last year, the PRIM Board stated its intent to publish its new set of proxy voting guidelines on its website. To date, this

has not happened, although several inquiries have been made about when such public disclosure might occur. Major stumbling blocks to fuller and more timely disclosure include the limited number of professional staff and inadequate information technology resources available to PRIM, not uncommon problems in these times of heightened public scrutiny.

The chief concern is the extent to which the Massachusetts public pension funds are fully utilizing their “wasted assets” in promoting responsible corporate governance and accountability to a range of empirical and ethical standards, especially since shareholders stand to lose both in terms of lost earnings as well as potentially costly penalties and fines.

For example, this past 2003 shareholder season, the PRIM Board voted on proxy resolutions addressing social and environmental issues at approximately 150 companies. With an eye toward the fiduciary duties of loyalty, care, and consistency regarding investment policy and beneficiary (and taxpayer) well being, in late June Rep. Marzilli requested the PRIM Board to disclose its votes on these resolutions; he had sent an earlier letter to PRIM on April 7th indicating his intent to request the proxy voting record toward the end of June, and attached a list of the companies and resolutions. On July 16, 2003 PRIM responded to Rep. Marzilli’s query with an itemization of how 115 proxies submitted to portfolio companies were voted; upcoming votes were still on the schedule for several companies, whose annual meetings are held in the late summer and fall.

Meanwhile, in early July Rep. Marzilli expanded his proxy disclosure focus to the nine largest Massachusetts public pension systems, asking them to report on both their proxy voting guidelines and voting records for resolutions addressing social and environmental as well as corporate governance issues. Letters were sent to pension fund board chairs for the state teachers, the City of Boston, Middlesex County, the City of Worcester, Cambridge, Plymouth County, Norfolk County, Barnstable County, and Worcester Regional.

This past spring, Rep. Marzilli filed legislation seeking fuller disclosure of proxy voting policies and greater transparency with regard to equity holdings. With legislative colleagues including Rep. Byron Rushing, an ardent advocate for responsible economic policies particularly on questions of human rights, Rep. Marzilli was the lead sponsor of four bills affecting the retirement system. Two of them made it to the public hearing stage: H.1186, “An Act Directing the State Treasurer to Publicly Disclose Proxy Voting,” was a bill requiring the state treasurer to publicly disclose proxy votes for companies in which the state is a shareholder; H. 1930, “An Act Relative to Corporate Accountability,” required PRIM to consider long-term liabilities when choosing investments, and, when appropriate, to avoid investing in them. It also required companies to publicly report long-term liabilities and public hazards, and authorize the creation of a new chapter of the General Laws to ensure “sunshine in litigation” and prohibit concealment of such hazards. Both H. 1186 and H. 1930 were heard before the Joint Public Service Committee on May 29, 2003.

The other two bills filed by Rep. Marzilli in 2003 contained specific guidelines for proxy voting. H. 1353, “An Act Relative to State Employee Retirement Investments,” directed fiduciaries of the state employee pension fund to withhold votes from the board of any company represented by a “non-diverse” board. H. 1354, “An Act Directing the State Treasurer to Vote in Favor of Certain Shareholder Resolutions,” required the state employee pension fund to vote in favor of shareholder resolutions asking for reports from the management of the portfolio company.

In addition to the testimony, on May 29, 2003, a subgroup of the Marzilli working group met with Doug Rubin, the Commonwealth's First Deputy Treasurer, to talk about various reform aspects of the PRIM Board's policies and practices. Rubin told the group that the new administration was conducting a thorough review of the pension operation, and had retained the services of McKinsey & Company in doing so. Joining Rep. Marzilli in this meeting were others who testified in support of the legislation, including Shelley Alpern, a widely respected proxy analyst and long time champion of corporate responsibility, fair labor, and human rights who serves as assistant vice president and director of social research at Trillium Asset Management Corporation, and Sanford Lewis, a gifted attorney whose practice represents investors, nonprofits, unions, and local government on matters of corporate accountability and environmental law. Lewis has done impressive work and organizing on behalf of the Alliance for a Healthy Tomorrow, which is a Massachusetts coalition dedicated to establishing new government policies to prevent public health injury due to toxic hazards. This author participated as well, in both the deputy treasurer meeting and the public hearings.

Why, Rep. Marzilli is asked, has he taken on the cause of responsible ownership, of civic stewardship? "I think that most people in public life, in public office, carry out two separate activities that are immediately linked in time," Marzilli says, reflecting on his role as a public steward. "In other words, we can vote for legislation affecting our tax and revenue code that generates money, which is then spent immediately by the governing parties on their programs. Embedded in both the act of taxation and the act of spending are some core values.

But there is a very limited understanding that in between the raising of the revenues and the spending of the revenues is a huge period of time during which these assets are held by public entities. There are values embedded there, too, but those values aren't measured. We worry about raising or lowering tax money, we worry about how we spend it, but we don't frequently think about how that money sits around.

The biggest manifestation of that is with the Commonwealth's pension fund. Massachusetts has billions of dollars sitting there, waiting to be paid out to retirees. It's money that comes from a mix of employee contributions and taxpayer contributions, but of course it doesn't sit around. It is invested actively across the portfolio. Because the investments are made in private sector entities, there is a long history of simply ignoring what those entities do. The goal is to maximize return. Some people misinterpret that to mean that only financial performance should be considered. I don't think that we have either the luxury, nor should we be so indulgent of professional investors, that we should do that.

It has been my thinking from the very beginning that the bulk of this nation's private sector investments and its businesses are owned not by individuals but by the public, but they rarely managed to benefit the public...Our dollars are being invested with very limited regard for the public interest. Yet we've always had the opportunity to vote in the public interest. So I filed this legislation....

It's only when people know what's happening to their lives, and to their investments, that they can take action. Short of real information, people get buffeted by politicized messages that don't necessarily reflect the reality of the situation.<sup>88</sup>

Good governance, wherever it exists, demands the informed consent of the governed. But "the governed" need to know what the issues are and how to affect them. This article has made the claim that the principles of "good governance" and "good citizenship" should be applied to "equity ownership," beginning with large institutional investors whose fiduciary mission is in service to their founding

purpose, values, and well being. Pension funds, endowments, and mutual funds are in a strategic position to make a positive difference regarding corporate power and accountability. Now is the time for them to develop codes and policies of fiduciary governance that put their mouth (and fiduciary ethic) where their money is.

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**Power and Accountability:  
Responsible Ownership, Institutional  
Investors, and the Democratic Ideal**

To begin to understand what we want with responsible ownership and fiduciary governance, we need to understand the characteristics of the evolving institutional investor world. We hear a lot about corporate and industrial misbehavior and the culpability of boards and senior executives, but we hear little about the owners of business enterprise, who are often equally to blame.

There are reasons for this, which are not fully addressed here. But as many chroniclers have noted, over the past 150 years there has been a steady drift away from direct ownership of publicly traded corporations. This is a phenomenon that, like a low-grade fever, poses a threat to our democratic way of life because “law and politics...serve the needs of the absentee owners at the cost of the underlying population.”<sup>89</sup> Economist and social analyst Thorstein Veblen was one of the first to chronicle this trend, which he called “*absentee ownership*.” (Veblen also coined the terms “*business enterprise*”, “*conspicuous consumption*,” and “*leisure class*.”)

Veblen’s ideas later were adopted and expanded by Adolphe Berle and Gardiner Means.<sup>90</sup> For the better part of the first half of the twentieth century, the idea of “absentee ownership” meant that shareholders were property owners, but theirs was an *intangible* or *indirect* form of ownership — a stock certificate being a far cry, for example, from a house, a barbershop, or farm.

Decades later, this “first stage” of absentee ownership gave way to a second stage. This one is characterized by what you might call the “ultimate absentee owners,” the ones who own stock but hand over residual rights and responsibilities to their agent intermediaries: the banks, the investment managers, the insurance companies, the index funds, and so forth. The gap between “owners” and “managers” widened even more with the rise of the institutional investor class, an occurrence that has evolved from a marginal to a major force since the late 1980s yet has remained primarily an invisible presence on the economic landscape.

This was the velvet revolution in property ownership, a low-key power shift with little bloodletting. For a brief period, the flurry of activism throughout the 1980s regarding South Africa-related investments turned the spotlight on institutional investors, especially college and university endowments and state and local pension funds. This was mainly because they faced pressure from protestors who gathered at college campuses, city halls, and state capitols to name and shame them into action. Foundations and charitable endowments did not have to worry about these pressures, because their primary constituents, their donors, were usually dead, and asset management was severely separated from program concerns.

After the noisy protests died down, throughout the 1990s other commentators and activists — most notably Bob Monks, Nell Minow, the U.K.’s Sir Adrian Cadbury, the California Public Employees Retirement System (CalPERS), TIAA-CREF’s Peter Clapman — have lobbied for better corporate governance and accountability, while analyzing the implications and challenges posed by the wide and disturbing gap between corporate ownership and control. Meanwhile, other big

public pension and labor funds began to press for change, asserting their muscle in pursuit of improved corporate performance, while social, environmental, and normative concerns receded.

On the accountability side, hundreds of voluntary corporate codes of conduct and various reporting and certification procedures have multiplied over the past twenty years, subjecting companies to greater scrutiny than ever before. The monitoring apparatus for increased corporate transparency ranges from relatively impartial research institutions to advocacy groups geared toward special interests. Improvements in technology and more widespread use of the Internet make information sharing on transparency and accountability more immediately accessible. A primary challenge, though, facing corporate boards and managers is how to increase transparency and accountability without subjecting firms to endless examination or analysis paralysis.

All of this monitoring attention and activity has concentrated primarily on the business corporation, while institutional owners have slipped off the radar screen. The time has come to put them back on it, and resume the momentum that began with South Africa-related concerns in the 1980s when institutional investors were called upon to develop and exercise their moral and financial authority, yet were a much less potent force in the capital markets than they are nowadays.

The \$18 trillion institutional investor terrain comprises roughly 75,337 organizations.<sup>91</sup> To put it mildly, there is very little sustained attention given to the emergence and behavior of this group, which now controls so much of the equity market, even if its power is relatively limited due to the intermediary role played by dozens of investment managers and other proxies. Even worse, while there is an overabundance of financial information out there, accurate descriptive information on institutional investors is extremely hard to come by and almost always characterized by a one- to two-year time lag. There is no central, reliable source telling us about a fund's type, origins, genetic traits, or behavioral and temperamental characteristics, mainly because, unless you are in a takeover mode, there are few incentives for gathering and disseminating it. This is probably no surprise. Information is power. With money, you can get both — not an acceptable condition in a democratic society.

Indeed, the public deserves a regular “census” of institutional investors that tells us who they are, what they look like, and where they reside. In addition to this descriptive information, the public deserves to know about the stewardship policies and practices governing their actions. Institutional investors are simply too powerful to remain invisible, and too autocratic to remain truly accountable.

In our system of democratic capitalism, every shareholder has a vote, and institutional investors, like political parties or caucuses, attract “voters” with respect to their “platforms.” Consistent with fiduciary law and expectations, these platforms should include planks on corporate governance and operations; on proxy voting (including guidelines, forms of analysis, and periodic monitoring and review); on board selection and continuing education (for both the investor board and portfolio companies); on how shareholder concerns will be conveyed to portfolio companies; on collective action with other investors; on how conflicts of interest will be handled (affecting investor funds themselves and their fiduciary agents); on what forms of public reporting and education will occur; on what sort of outside agents will be retained to provide research and advisory services, or otherwise help to fulfill the fiduciary role; and so on. Most of these positions are nowhere to be found within fund marketing materials, prospectuses, and annual reports. They should be.

This, too, is unacceptable in a democratic society, particularly given the heightened awareness of the impact of markets on all of us, including those less fortunate or in a position to retaliate, such as regulators are now able to do. As was discussed above, beginning in mid-2004 U.S. mutual funds will be required to submit Form N-PX to the SEC, which contains a complete proxy voting record for each matter relating to a portfolio company considered during the previous year; the funds will also be required to make these proxy voting records available to shareholders, either on websites or by mail.

Unaffected by the SEC ruling, however, are other investors, such as state and local pension funds and charitable endowments. Some state pension funds are beginning to consider proxy guideline and disclosure requirements. State officials in Connecticut, Vermont, and New York announced their intention to do so last April at the annual CERES conference.

The time has come for all institutional investors, of whatever stripe, catch up to their private sector and mutual fund brethren. Institutional investors possess a franchise that is simply too precious to waste; moreover, not exercising it leaves the rest of us vulnerable to special interests and self-dealing. But disclosure is not enough. Attention also should be paid to the range of responsible ownership activities, beyond the ballot.

First, **we need to develop a fiduciary creed**, a normative theory of responsible ownership and fiduciary governance, for evaluating the actions of institutional investors. Disclosure means little in a vacuum. We need better models for gauging good fiduciary governance, a process that can benefit from current work in the realm of corporate governance and the groundbreaking work of the International Corporate Governance Network. And we need not look too far: the enduring (but somewhat battered) American political philosophy of constitutional civic democracy will do quite nicely.

Second, **we need high quality programs on investor education**, perhaps drawing on some of the resources unleashed by the Wall Street settlement if they have not already been locked up by special interests. Included here are executive programs on fiduciary governance and responsible ownership, with stronger ties to reputable academic and research communities, which in turn need to be more closely aligned to the needs and reality of practitioners. Good theory comes to life in good practice, and good practice relies on good theory to remain that way.

Third, **we need to recognize the power of collective networks**, especially among institutional investors with shared interests. In a significant essay on “Envisioning Socially Responsible Investing: A Model for 2006,” Steve Lydenberg, one of the most thoughtful and perceptive observers on the scene, calls for new institutional investor associations sharing concerns about social and environmental issues. “Once dialogue among these investors embraces such issues, the adoption by corporations of formal programmes and internal policies on these issues will not be far behind,” Lydenberg writes. He continues by pointing out the important work of CERES (the Coalition for Environmentally Responsible Economics) on its Sustainable Governance Project, which links climate change to corporate liability and risk exposure.

Written in 2001, Lydenberg’s article is a must-read, and identifies major initiatives that need to occur over the next three years within three communities: the corporate community, with increased attention to mission, stakeholders, and disclosure; institutional investors, with increased responsibility for voting, public disclosure of social investment policies, and increased intra-industry dialogue on

social and corporate governance issues; and the financial community and its academic and advocacy group analogues, with increased attention to education, training, and the professionalization of the socially responsible investing and corporate social responsibility disciplines. It appears in the Autumn 2002 issue of the *Journal of Corporate Citizenship*, a publication of the United Kingdom that can be accessed at [www.domini.com](http://www.domini.com)

Fourth, in addition to an agreed-upon theory and framework for responsible ownership as well as fund disclosure and reporting, the public also would benefit from **a rating system that compares fiduciary governance policies and practices**, and scores them according to a series of important categories covering the level of participation, accountability, and representation. Such a framework would review investor boards of directors; institutional charters, mission and values; who the beneficiaries are; responsible ownership policies and practices (which include, but are not restricted to, proxy voting); proxy voting policies and practices; disclosure, reporting, and public education; conflicts of interest safeguards; collective action with other investors; director qualifications and continuing education; outsourcing of ownership responsibilities; and so on. Such a comparison of fiduciary governance performance could help serve as an incentive to improved functioning, in keeping with some of the principles outlined in this article.

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### **Institutional Investor Dollars and Sense: A Profile**

So where does one turn to obtain baseline information on who, and what, these investors are? Some publicly available surveys do provide credible descriptive information; for example, the Investment Company Institute issues weekly reports on total mutual fund assets; pension assets for the largest funds are reported in *Pensions & Investments*; *The Chronicle of Philanthropy* publishes an annual roundup of foundation assets; and Carolyn Brancato's *Institutional Investment Report* published by The Conference Board contain valuable summary information.<sup>92</sup> One has to proceed piecemeal through various sources, some of which are terribly outdated, and often confront hefty subscription fees, to boot.

As already mentioned, altogether an estimated 75,337 institutional investors own assets worth more than \$18 trillion. Within this universe, there are about 19,000 endowments with combined asset values of approximately \$951 billion. This category of nonprofit institutions includes colleges and universities; churches; public charities; social purpose institutions such as museums, hospitals, and educational groups; and grantmaking institutions called foundations (there are different classes of these, too, with different philosophies, cultures, structures, and reporting requirements, including private independent foundations, family foundations, corporate foundations, operating foundations, and community foundations).

U.S. foundations in 2000 had combined assets of \$486 billion, the most recent year for which data are available. (Not surprisingly, most foundations have reported a drop in asset value over the past three years, prompting many to reassess their mission, cut staff, and reduce their grantmaking.<sup>93</sup>) The assets held by more than 600 community foundations (think of them as philanthropy's Main Street, much like the average person's philanthropic mutual fund) were \$31.4 billion by year-end 2001, a slight drop from the previous year's total of \$31.6 billion and the first decline in ten years.<sup>94</sup>



Totaling some \$3 trillion, state and local pension funds now devote 69.3% of their assets to equities, up from 36.1% in 1990. This increase reflects a widespread trend on the part of these public pension funds to diversify their portfolios into equities from their historically more conservative investments in the bond markets.

Meanwhile, union funds (also known as Taft-Hartley funds) hold an estimated \$400 billion in assets. AFL-CIO and the Teamsters funds are among the most ardent advocates of shareholder rights and responsibilities.

U.S. mutual funds, which by year end 2002 held more than \$6.5 trillion, amassed considerable amounts of equities over the 1990s and have become somewhat more engaged in corporate governance matters.<sup>95</sup> In 1990 mutual funds allocated 23 percent of their total assets to equities, which represented only 6 percent of the total equity market; by year-end 2002, mutual funds had increased equity investments to 58.8 percent of their total assets, representing about 21 percent of the total equity market.<sup>96</sup>

Within the mutual fund category are hundreds of social responsibility funds, with new ones being announced all the time.<sup>97</sup> In 1999, Domini Social Investments was the first to publicly proclaim its responsible ownership policies, including how proxies were to be voted. As noted above, following the late January SEC ruling on proxy disclosure, beginning in 2004 all mutual funds will be required to make such disclosures, in large measure thanks to a broad coalition of concerned individual and institutional investors.

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### **Missing in Action: Institutional Fiduciary Governance Policies and Practices**

As for individual fund reporting on stewardship policies and practices, some activist funds such as TIAA-CREF, CalPERS, and those representing union or social investors do so, sometimes even electing board members from beneficiary ranks.<sup>98</sup> As already mentioned, there is no instrument for reporting on or comparing institutional fiduciary governance policies, and little data on best practices that can be shared with a wider audience. What exists remains anecdotal and episodic. By and large a thick fog hovers over the institutional investor terrain, which needs to be lifted, because you cannot get to where you want to go before you have an accurate picture of what you are confronting.

Behind these numbers are some general patterns and themes.

First, most *beneficiaries* — the teachers, firemen, police, service workers, small business owners, insurance policy holders, average person with a 401(k), a given nonprofit organization or university or church or foundation — are several stages removed from the decision making regarding their money, even though it is in their name and interest that all investment decisions are being made;

Second, one could classify this “beneficiary dislocation” into three types, Type I being the “nearest,” Type III being the “furthest” from the investment decision maker or fiduciary. In other words, Type I beneficiaries have “in house” structures for investing their money, such as TIAA-CREF does. They remain closely involved with asset management, and meet directly with corporate boards and senior executives to assure their concerns are addressed. They are active investors in the sense that they exercise their franchise as shareholders and maintain open communication with the class of beneficiaries they represent. They also observe the delegation of governance and management authority to *their own* boards and executives,

as well as those of the corporations in which they hold equity stakes. In general, TIAA-CREF is an exemplary model of responsible ownership and fiduciary governance.

Type II beneficiaries rely upon special managers, mutual funds, or index funds that reflect their values, placing them in customized vehicles that are designed to harmonize with their interests such as many church and social investors do, or Harvard University, which relies upon the Harvard Management Corporation, which also invests the assets of other colleges, such as Wellesley.

Type III beneficiaries rely upon outside managers or funds that service multiple clients. Type III beneficiaries are institutional investors that provide very little direction or monitoring, other than regarding asset allocation and whether or not financial targets are met. Type III beneficiaries are the vast majority of investors, reflecting the tendency to delegate all financial matters to the “experts,” even though, technically speaking, institutional investor *fiduciaries* — that is, a given fund’s board — are responsible for the performance of assets, in accordance with general assumptions about fiduciary responsibility (which are, of course, entirely subjective and subject to constant change and modification).

To repeat: Most institutional assets *held* or *owned* by institutional investors are actually *managed* by somebody else — the money managers, investment companies, financial advisors, and the like. These intermediaries are supposed to *reflect beneficiary sentiments, acting in their best interest and taking direction from them*. In practice, however, it usually occurs the other way around: Fund managers pitch their wares according to their sentiments and market niche, give direction to beneficiaries, and are judged on the basis of financial performance alone. They provide little or no guidance on good investor governance and vote proxies automatically, usually in favor of management and with little or no critical analysis.

This is an unacceptable state of affairs.

*All institutional investors, no matter what type they are, have some sort of governance structure enabling them to formulate principles, norms, and rules, ratify them, and monitor the extent to which performance of their financial assets follows suit, including the opportunity to evaluate and make adjustments as needed.* In general, this is carried out by a standing board committee on finance or investments; financial reporting usually is conducted by an outside, impartial auditor, and is contained in an annual report. In practice, investment committees rely heavily on the advice and counsel of various parties, an organization’s chief financial officer, accountants, legal advisors, portfolio managers, financial advisors, economists, and the like, and often do not pay attention to many of the governance, ethical, or social policy implications of their investments. In effect, they preside over “wasted assets” because they have not fully exploited their power as owners.

Attention, therefore, should be paid to the “real” beneficiaries, not just their hired guns, to *their* sentiments and interests, not those of their representatives who may not pay attention, and to the structure and manner in which they order their decision making. Each and every one of these 75,337 institutional investors represents “islands of governance,” self-contained regimes possessing rights and responsibilities that determine what they do with their dough.<sup>99</sup> Properly understood and executed, these powers can help assure greater levels of participation, accountability, and representation, thereby cultivating an ethic of civic stewardship. They include the authority to make policies for allocating and investing assets, selecting agents to help them discharge their fiduciary responsibilities, monitoring them, developing policies for and voting proxies, obtaining the views of

beneficiaries, engaging in dialogue with senior management of portfolio companies (but not meddling), joining forces with other investors on matters of mutual concern, reporting to the public, reducing conflicts of interest, continuing board education, and so on. Like good citizenship, good fiduciary governance serves as a vital component of a deliberative democracy and helps to assure that capital markets work *for* us, not against us.

As has already been mentioned, each institutional investor represents an island of governance, with values, responsibilities, and rights as corporate owners. They have governance regimes that prescribe and restrain what they do with their money — and hold a franchise to influence corporate behavior.

As a starting point, we should ask if our favorite pension or mutual fund, charity, religious, cultural, educational, trade union, or other type of nonprofit institution — including foundations — has a sound policy, standards, and procedures for proxy voting. If they don't, we should encourage them to develop one, and then make sure they report on its implementation. If they do, we should ask how it reflects their institutional values, and what mechanisms are in place to maintain its vitality. We should find out if environmental and social risks are addressed, as well as economic ones.

Eventually, we should examine other aspects of their own governance, to gauge adherence to the fiduciary duty of care, loyalty, and consistency. Areas that should be examined include investor board selection, qualifications, education and training; delineation of board duties and priorities as opposed to those of management; methods of assuring compliance with applicable law, including information gathering and reporting; degree of board independence; outsourcing to financial / fiduciary advisory and consulting firms; fees and transaction costs; procedures for identifying and handling conflicts of interest, particularly regarding lawyers, fund advisers, proxy managers, and money managers; board and executive compensation; methods of evaluation that include normative criteria; public communication and education; overall transparency, accountability, and independence; voting guidelines and disclosure; engagement with portfolio company management; corporate monitoring and oversight; alliances with other investors; and working relationships with other academic or research institutions.

There are many reasons that this is important, not the least of which is to ensure that the values, sentiments, views, and needs of beneficiaries — call them clients or customers, but they also are citizens who want to preserve their freedom, dignity, and security — are at the epicenter of this decision making, and, with Types II and III beneficiaries, that they are communicated to the money managers and other financial intermediaries so that, in turn, corporate boards get the message, too. This is common sense and the right thing to do. It also fulfills the truest meaning of “fiduciary responsibility,” now expanded to include the virtues of civic stewardship.

Put another way, this means that attention should be paid to the governance regimes that institutional investors use to communicate their responsibilities and rights as owners to those responsible (e.g., money managers, investment advisers, banks, insurance companies, corporate boards) for the assets they own.

It means that the same procedural values of good governance that apply to our corporate, public, and nonprofit institutions — including transparency, accountability, participation, and representation — should be applied to institutional investors, as well.

It means that the franchise granted investors — one share, one vote — should be exercised freely and fairly — and made public, an expectation affirmed by the SEC

earlier this year in its directive to mutual funds and investment advisers. But voting alone is not enough. Institutional investors must learn to vote wisely and well.

Fiduciary leadership, governance, power, and accountability, as yet relatively uncharted terrain in the vast and diverse world of capital markets, economic globalization, and corporate governance and management, represents the new frontier of civic stewardship and responsible ownership, and demands serious and sustained attention with the best qualities of common sense and civic virtue.

At its core, then, fiduciary governance, power, and accountability *extends democracy laterally* — providing shareholders a voice, devising standards and structures of representation and accountability, and assuring that the broader values of republican governance and democratic civil society are embedded in ownership norms and procedures, an idea as old as the Republic itself.

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### **Common Sense and Civic Virtue: Madison's Ghost and Fiduciary Governance**

James Madison is considered to be the father of the American Constitution, whose proposed set of checks and balances relied heavily on the notion of trust and civic virtue. His view of government was that it serves as umpire, arbitrating among competing interests in pursuit of a just balance. He viewed direct democracy as unjust, in part because self-interest would bias judgment and mitigate the common good, perhaps even leading to majority tyranny. A better approach, Madison believed, is a representative democracy, a republican government, with public officials freed from parochial ties through term limits, periodic elections, and, save for egregious deeds, no recall.

Madison's idea of governance, of self-governance, was that it was a calling, something rooted in civic virtue and an extension of fundamental principles of integrity and honor. This was so because you needed to have officials in whom you could trust, who also could be counted on to adjudicate multiple interests against a standard of wise statecraft. Madison understood that human nature being what it is, the structure of governance is not enough, however carefully thought out and ratified; human passions have little patience for organizational charts, statutes, and rules of order. Ultimately, the character and conduct of ordinary citizens, and the character and conduct of their elected representatives, would determine the fate of the fledgling nation:

I go on this great republican principle, that the people will have virtue and intelligence to select men of virtue and wisdom. Is there no virtue among us? If there be not, we are in a wretched situation. No theoretical check, no form of government, can render us secure. To suppose that any form of government will secure liberty or happiness without any virtue in the people is a chimerical idea. If there be sufficient virtue and intelligence in the community, it will be exercised in the selection of these men, so that we do not depend on their virtue, or put confidence in our rulers, but in the people who are to choose them.

Two hundred-twenty years later, we should pay heed to Madison's faith in the ordinary citizen and think about whether it is justified. We also might consider its relevance to ordinary shareholders, who have such an important role to play in corporate governance, itself a system of checks and balances that is based upon the republican model. This article has argued for the idea of fiduciary governance, brought to life by the principles of common sense and civic virtue yet preserving the vision of the American ideal.<sup>100</sup>

Unwittingly evoking Madison's ghost, in a conversation last summer, Boston (and New York) lawyer *cum* civic leader Martin Kaplan of Hale and Dorr coined the term "citizen shareholder" to capture the essence of this revolutionary kind of fiduciary governance.<sup>101</sup> Kaplan is in a position to know: A recently retired yet longtime member of The Boston Foundation board, he was partly responsible for a model of institutional investing unlike any other in the nation. Spearheaded by Wainwright Bank co-founder and current TBF board member Robert A. Glassman (who chaired the foundation board's investment committee at the time the policy was adopted), along with former Boston Foundation president and CEO Anna Faith Jones and James A. Pitts, currently TBF senior vice president for administration and finance, in 1999 the \$550 million Boston Foundation developed a values-based civic stewardship policy that emphasizes proxy voting power with the corporations in which it holds stock.

This was three years before Enron, and long before other institutional investors were aware of the "wasted assets" they hold.

Now in its third year of implementation, the policy is rooted in TBF's guiding values of access, equity, diversity, fairness, and respect. It finds expression on proxy issues related to the environment, community well being and citizenship, diversity and equity, and good corporate governance, and is available to the public on the foundation's website, [www.tbf.org](http://www.tbf.org). (*Full disclosure*: I was retained as an advisor to The Boston Foundation's board to help them craft and articulate this civic stewardship policy and guidelines. The Foundation currently relies on Institutional Shareholder Services to help with implementation.)

"Most community foundations would espouse a whole range of well thought out, and certainly worthy, series of values that are embodied in their programs, but historically they would have a kind of Chinese wall between that and their investment stewardship," says Bob Glassman, who took over as investment committee chair from David Rockefeller, Jr. in 1995, and was the lead player in helping The Boston Foundation achieve discretionary authority to make its own investment decisions (which was no mean task). Glassman is well known for successfully integrating a deeply felt commitment to social justice into his professional and public life; as a result, he has many lessons to impart to others wishing to embark on a similar path. "It occurred to me that that was inconsistent...

If you asked community foundations whom they supported programmatically and how committed they were, it would be very clear. But if you ask them if they understood the impact they're having on the investment side, they would give you a blank stare. [They did not comprehend] the instrument with which shareholders impact the corporations, which is proxy voting. Shareholders, as owners, are the corporation's bosses, with corporate management truly the hired hands. The goal for me at The Boston Foundation was to have the foundation be involved and engaged.

I guess I was seeking that kind of constructive engagement at first, so that they would take a position. It didn't necessarily mean that it had to be my position, but it had to be a position that the majority of the board saw as being consistent with the values that it talked about in the annual report, the values that it espoused programmatically, and the values that the organization would otherwise say it stood for...

So how does one then go ahead and engage the board of directors on an issue that for the better part of 75 years was not high on its agenda? "It took a good deal of effort to eventually create a kind of moral symmetry between the kinds of things we said we stood for and the actions we took through the investment portfolio," Glassman recalls, citing the challenge of integrating a policy affecting the federally

mandated 5 percent payout of foundation endowment assets with the other 95 percent. “Beginning with its decision in 1985 to address the question of South Africa-related holdings, to 1995 with the passage of the ‘Harmony Statement,’ to 1996 with the decision to divest tobacco stocks, The Boston Foundation had attempted to fulfill its stewardship obligations in ways that advance its public mission,” he said.<sup>102</sup>

As the foundation’s chief financial officer, Jim Pitts is charged with the responsibility of making sure the policy is implemented, which includes setting up the right systems and quality controls. A seasoned and skilled administrator with decades of experience in corporate and nonprofit management and finance, Pitts relished the challenge and embraced it with integrity. “From a practical point of view, I would say that beyond the process of getting it through the board, the mechanical aspects [of the proxy policy] were very easy,” he says, when asked to reflect on the matter. “But that was one of my preconditions for even entertaining the idea, which was that it had to be administratively clean and not burdensome from a staff point of view.”

Aside from initial glitches affecting communication with Proxy Monitor (now a part of Institutional Shareholder Services), Pitts considers the civic stewardship policy a success, and that it has persuaded others that “nothing crazy and embarrassing can happen.” A key reason, he notes, is the articulation of a guiding philosophy and set of principles that square with The Boston Foundation’s charitable mission, and the fact that there is considerable administrative leeway when it comes to voting proxies. Initially, the board vehicle for this was the investment committee’s proxy voting subcommittee; the proxy subcommittee now longer exists, he says. One can foresee a time, however, when it may need to be revitalized.

“I guess I would say that I learned — and I hope the [foundation] board would agree with this — that once the board agrees in concept, carrying it further in terms of adding on a lot more issues is not difficult at all, because there’s an agreement in principle that if we have a set of values in our articles of incorporation or annual report, that we’re going to follow through with it in each and every way.” Pitts is such a fervent believer in The Boston Foundation’s responsible ownership role that he is working with other community foundations to “get on the bandwagon” and regularly fields requests from institutional investors as to how best to do so.<sup>103</sup>

One of the nation’s oldest (it was established in 1915) and largest community foundations, The Boston Foundation has nurtured an ethic of democratic capitalism that recognizes the moral and economic value of the proxy vote, something that needs to occur throughout the institutional investor galaxy. As Bob Glassman and Jim Pitts have argued, foundations, in particular, are in a good position to bridge the gap between programs and proxies while braiding their economic, civic, and moral commitments into decisions about asset management, not just the 5 percent assets they are required to pay out each year in grants and administrative expenses.<sup>104</sup>

“We took what turned out to be a historic role in our industry,” says Glassman, referring to the 600-plus community foundations around the country. “The Boston Foundation has become a model for many other foundations, and I think the board is particularly pleased that the seeds were already planted before anyone ever heard of Enron. A number of folks are calling and asking how we can help them establish a similar mechanism, and our proxy voting policies are now on our website.”<sup>105</sup>

What is the best way of going about this? What advice does he have for other institutional investors? Along with Marty Kaplan, Glassman conveyed some of the

lessons learned to a group of interested foundation folk at a meeting convened by the New York-based Nathan Cummings Foundation on January 24, 2003. Among Glassman's recommendations:

- never underestimate the importance of board education, which means devoting a good deal of time and effort to help a board understand the full meaning and implications of its fiduciary role. This includes understanding that having no policy is the same as having a policy, because fund managers generally vote to support management's position unless there is a directive to do otherwise. A key point is to have a triumvirate of at least one engaged and interested board member, working closely with the foundation's management team and outside expertise, not only to "change the mindset" but tailor a plan that fits the foundation's unique circumstances;
- rely on quality dispassionate information and analysis, because often there are many competing ideologies and views on foundation boards, which can easily complicate the policy-making process. When developing an asset management policy of civic stewardship, foundations are well advised to begin by sticking to the values and principles that drive their charitable mission, and then proceed to translate them into a policy and guidelines for investing, voting resolutions, and other actions that put their principles into practice;
- communicate the civic stewardship policy and guidelines to others, which not only educates the public, peers, and colleagues, but can be a great way of encouraging prospective donors to consider the foundation as a vehicle for leveraging their financial contributions in more ways than one;
- keep your eye on the larger prize. The proxy voting process, after all, is about 'getting out the vote,' which is central to our democratic tradition. Foundations are perfectly poised to address our corporate governance crisis by helping to restore much needed trust and accountability in capital markets.<sup>106</sup>

At a time when the robustness of their endowments has sagged, The Boston Foundation and a handful of other foundations have forged ahead anyway, recognizing that there are other means at their disposal. As mentioned, the Nathan Cummings Foundation has played a catalytic role in helping to mobilize larger foundations and educate them about opportunities they have as responsible owners. In a recent article addressed to her cohorts in the foundation community, Caroline Williams, chief financial and investment officer at the Nathan Cummings Foundation, writes, "The value of your foundation's endowments may be down, but the actual number of your proxy votes, and therefore, your capacity to have an impact on corporate behavior, has not diminished. It is in our own interests, financially and, therefore, programmatically, to become knowledgeable and active in voting proxies."<sup>107</sup>

The impetus for Nathan Cummings' recent efforts began, Williams says, when Tim Smith of Walden Asset Management and the Social Investment Forum approached them with a request to co-convene a meeting of activist foundations, and talk about specific proxy initiatives. Along with Smith and Melissa Berman of

Rockefeller Philanthropy Advisors, the meeting was held in late January 2003 to gauge foundation attitudes toward moving forward. A decision was made to include only larger funds, and hold off on the activist domain until there was some sense of where participants wanted to go. And, financial rather than program staff were invited; officials from The Boston Foundation and the Charles Stewart Mott Foundation shared their approaches. Attendees were provided with information on both the 2002 and 2003 proxy season, including a summary analysis of major issues and resolution filers.

The hope, Williams says, was to generate discussion on areas of common interest across institutional lines. Little did they know that the Securities and Exchange Commission would generate such major and timely buzz with its announcement on proxy voting. “It was fortuitous timing that our meeting was the day after the SEC decision on mutual funds and investment advisers, which gets to the question of who’s voting the proxies,” she says, referring to the highly anticipated ruling. “Who pays attention? The standard answer is usually the money manager votes it, because the manager is the one who knows the company and the stock and the management, so they’re the ones in the best position to evaluate it...

Now there’s an opportunity to ask the money manager questions, and to get yourself up to speed in terms of what’s going on. Now you can ask your managers what they’re doing and why, which is a great way to learn more about what’s going on, even if you’ve never looked at the issues and you have no opinions on any of this.<sup>108</sup>

In late 2002, Lance Lindblom, the president and CEO of the Nathan Cummings Foundation, made a similar argument. In an essay appearing in *Foundation News & Commentary* entitled “We’re Owners, Not Traders,” Lindblom argued that because foundations are major investors in corporate America, holding roughly \$400 billion in U.S. equities, they “need to recognize and exercise the responsibilities of ownership. We can vote our values with our investment dollars, but the real leverage for change is an asset that most foundations ignore — the proxy vote. It is a right and a fiduciary obligation to vote the proxies we hold in accordance with our foundations’ values. The power of the proxy can coordinate and integrate the intellectual, financial, and programmatic resources of our foundations to advance our missions more effectively and strategically.”<sup>109</sup>

Lindblom and Williams, like Glassman, Kaplan, and Pitts, are following in the footsteps of others who blazed an earlier trail amidst the forest of endowments, going back to the efforts of the late visionary and political leader Paul Ylvisaker and others in the early 1980s, and religious investors throughout the 1970s. On the foundation side, notable among these early pioneers is Steven Viederman, who as president of the Jessie Smith Noyes Foundation was a staunch advocate of “mission-based investing,” which included proxy voting among a range of available techniques. Viederman also was instrumental in organizing the Shareholder Action Network, a device for alerting progressive investors on issues of special concern. For many years, the Jessie Smith Noyes Foundation was the most prominent of a handful of endowments to bridge the program and asset management divide. Since leaving the Jessie Smith Noyes Foundation, Viederman continues to promote the notion of civic stewardship through the Initiative for Fiduciary Responsibility, which is aimed at helping institutional investors learn how better to align their investment and program objectives.

“Fiduciary responsibility requires consideration of the social, environmental, political and cultural effects of investments, both positive and negative, over the



short- and long-term as a fundamental part of the investment process,” he writes in “New Directions in Fiduciary Responsibility,” which appears online. “This view of fiduciary responsibility and the obligations of fiduciaries is not a radical approach to institutional investing.

In fact it is very conservative, making the best use of all available information that can positively and negatively affect financial returns...It is essential to move away from outdated views of prudence and fiduciary responsibility to a new, broader conception that considers both long-term societal considerations and shareholder value as mutually supportive. Transitions take time, but we must begin now.<sup>110</sup>

As already pointed out, in recent times TIAA-CREF, the New York City and California pension funds, the AFL-CIO and other labor funds, and Domini Social Investments also have been pacesetters. But they are not endowments, possessing a deliberate public or charitable mission. To combat the current abuse of corporate power and fiduciary trust, others, especially foundations and other types of endowments, should take The Boston Foundation’s lead. Needed is a new kind of “voter education project,” dedicated to “shareholder suffrage” that improves the ability of institutional investors to do their job. The opportunity to influence corporate governance and accountability without new laws or regulation is irresistible. All it takes is the recognition on the part of investor governing boards that “good governance” begins at home.

Institutional investors are in a good strategic position to *strengthen* — through active engagement and oversight — and *broaden* — through an expansion of the meaning of “value” to ethical and normative realms — their role as owners and their commitment to “capital appreciation” and “return on investment” to make it more productive. As representatives of the vast number of individual investors and donors, their franchise is a fundamental part of the principal-agency relationship and its underlying fiduciary principle. Not exercising this franchise and not behaving as responsible owners leave us vulnerable, as we have seen, to special interests and self-dealing.

The power of responsible equity ownership and the proxy vote to give voice to shared civic commitments that are consistent with investors’ fiduciary mission provides a powerful nongovernmental alternative to the current crisis of corporate governance, helps to restore trust in our capital markets, and strengthens our republican tradition of democratic self-government.

We need to ignite a movement for responsible ownership and fiduciary governance that relies on common sense and civic virtue, and recognizes that the impact of the capital markets and the business corporation can be influenced in constructive ways through machinery that already exists.

Responsible ownership and fiduciary governance involve active trusteeship, made possible by a public commitment to **substantive principles** reflected in ethics, values, and normative standards, and **procedural principles** reflected in the democratic virtues of participation, accountability, and representation.

Responsible ownership and fiduciary governance recognize that both financial and non-financial criteria need to be incorporated into economic decision making, because capital markets and the business corporation affect human lives as well as the bottom line.

Responsible ownership and fiduciary governance elevate the meaning of “return on investment” to something larger, to a future marked not just by material prosperity but also by civic and environmental well being.

Rightly understood, responsible ownership and fiduciary governance return the principles of common sense and civic virtue to the marketplace, where they used to reside. Put another way, responsible ownership and fiduciary governance are about appropriating a tradition that gave rise to the birth of the American republic, a tradition preceded in antiquity as fundamental to public life, which was that property ownership and wealth carried with them moral responsibilities for the common good.

These are American values, but they did not begin here, nor are they restricted here. They are human values that, within a global context and a changing landscape of world politics, have extraordinarily important implications. The governance crisis facing us, and the assault on the democratic ideal that permeates modern life, can and must be confronted, and confronted in ways that are consistent with these values. As Mom would say, “This, too, shall pass,” but not without improving things. Rather than sitting there passively, institutional investors should consider themselves citizen shareholders and then get busy. They should seize the moment to take back the power they already have, learn how to use it well, and give fresh meaning to the idea of “wise statecraft.”✂

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## Notes

1. See Frank Rich, “Religion for Dummies,” the *New York Times*, April 27, 2002. Rich refers to the Congressional testimony of disgraced former Enron executive Jeffrey Skilling, who told the official investigative committee of an earlier conversation with a “shame-filled fellow Enron executive” who said they were being called child molesters, and “that would never wash off.” The remorseful executive later committed suicide after making these figurative accusations; in the case of the Catholic Church, they were literal, “and only the church itself, by its own actions, can determine when the stain will wash off....It’s depressing when the nation’s spiritual mentors sound like businessmen fending off indictment, whether at Enron or Merrill Lynch — or, worse, like buck-passing politicians on the order of that preacher’s son Gary Condit,” Rich continued. “But the abdication of personal responsibility by some religious leaders in America is only half of the confused moral equation since Sept. 11. If too many religious leaders sound like politicians right now, the flip side is that more and more politicians in power are rushing into the ensuing vacuum. They exploit the exigencies of war to sound like clergymen, seizing religious language to veil partisan public policies in a miasma of ersatz godliness.”
2. “Many boards of directors of foundations and charities, both large and small, are still failing to exercise their responsibility in ensuring the financial and programmatic health of the organizations they oversee,” says Pablo Eisenberg, longtime watchdog of organized philanthropy and nonprofit organizations. “While the public is demanding increased accountability and transparency from nonprofit organizations, a number of them continue to operate as though they are immune from scrutiny and impervious to ethical standards of behavior.” See Pablo Eisenberg, “The Buck Stops With the Board of Directors — or at Least It Should,” *The Chronicle of Philanthropy*, October 17, 2002. For an analysis of how the new mood affecting corporate power and accountability will affect the governance and operation of charitable institutions, see Patrick K. O’Hare, “A New Measure for Accountability,” *The Chronicle of Philanthropy*, October 31, 2002. “Nonprofit groups will need to pay close attention to the [Sarbanes-Oxley] corporate-responsibility measure,” O’Hare writes. “States that have experienced large nonprofit bankruptcies or public scandals are likely to consider adding provisions similar to the federal law so that they cover charitable organizations...Nonprofit groups would be well advised to become familiar with the new governance provisions and to make an assessment of the wisdom of adopting some or all of the requirements before donors, regulators, insurers, and the press begin to question why charities hold themselves to a lesser standard of governance than their for-profit peers.”

3. Interview with Robert A.G. Monks, February 14, 2003.
4. For decades, going back to the 1860s when industrialization caused businesses to get bigger and made stockholders increasingly distant and passive regarding corporate affairs, the primary recourse for dissatisfied owners was to sell their shares — dubbed the “Wall Street Walk” or the “Wall Street Rule” — thereby sending an indirect message to management that change was needed. More recently, especially within the past 15 years, shareholders have begun to assert their roles more aggressively, a development I chronicled and analyzed in *Corporate Civic Responsibility and the Ownership Agenda: Investing in the Public Good*, an Occasional Paper prepared for and published by the John W. McCormack Institute of Public Affairs at the University of Massachusetts Boston in March 1994.
5. See also “In Praise of Trial Lawyers,” *The Economist*, July 10, 2003. “Shareholders of bankrupt firms can only win by teaming up with Mr. Lerach,” it said. He and his partners have “built a career on championing the shareholder lawsuit, a legal device that most American bosses see as a form of legalized extortion...Such has been their success that the firm may have become too big to manage.”
6. Monks interview.
7. The AFL-CIO has achieved some important gains on this front.
8. Interview with Kenneth B. Sylvester, May 22, 2002.
9. See Division of Corporate Finance, Securities and Exchange Commission, *Staff Report on Review of the Proxy Process Regarding the Nomination and Election of Directors*, July 15, 2003: 9.
10. Monks interview.
11. Nell Minow email to author, June 10, 2003.
12. In October 2002, the *Financial Times* reported on Monks’ latest efforts. “Attorney William Lerach and corporate governance activist Robert Monks are to join forces to advance a radical shareholder rights agenda through the US judicial system,” it said. “Lerach is currently preparing cases against several prominent US corporates — including Sprint Corp. (FON), Qwest Communications (Q) and AT&T Corp. (T) — to force them to revise their board compositions, executive compensation packages, and other governance related policies. Lerach said the planned litigation was best described as ‘corporate governance at the point of a gun.’ ‘We have tried to persuade corporate America to change through traditional shareholder actions,’ said Monks, ‘But are we getting anywhere with this? The answer is, we’re not. So now we’re going to try, not as shareholders, but as plaintiffs.’ Lerach’s law firm, Milberg Weiss Bershad Hynes & Lerach will finance the lawsuits. The International Corporate Governance Network (ICGN) this week recognized Monks with its award for excellence in global corporate governance.” See “Activists Turn Up the Heat,” *Financial Times*, October 4, 2002, appearing in *Corporate News Briefs*, October 30 — November 5, 2002, Vol. 4, No. 40 (Portland, Maine: The Corporate Library).
13. “Investors should be less concerned with what the governance policies say, or what I call ‘resume independence,’ than they are with the practice of independent judgment,” says Portland Maine’s Corporate Library editor Nell Minow. “We do not evaluate directors on what they say they do; we evaluate them on what they actually do. We grade them on how well they handle the toughest calls.” The Corporate Library’s “Ten Worst Large U.S. Boards” include Allstate Corporation, Citigroup, Inc. (declared “Worst Overall”); Emerson Electric Company; Gemstar-TV Guide International, Inc.; Honeywell International, Inc.; J.P. Morgan Chase & Co.; Loews Corporation; SBC Communications; Verizon Communications; and Walt Disney Company. Free trial access to The Corporate Library’s Board Analyst database, including a sample of the new Board Effectiveness Ratings, is available by contacting <mailto:ratings@thecorporatelibrary.com>. See also “Citigroup Has the Highest Risk Board in the U.S., According to The Corporate Library’s New Rating of Corporate Directors,” Press Release, The Corporate Library, Portland, Maine, June 9, 2003, and Monica Langley, “Big Companies Get Low Marks for Lavish Pay to Executives,” *Wall Street Journal*, June 9, 2003.
14. Last November, *New York Times* reported that companies that award top executives with extravagant option packages produce lower returns to shareholder than those that allot fewer options. An academic study by Joseph Blasi and Douglas Kruse, human resource management professors at Rutgers University, ranked the top

- 1,500 US companies on the amount of options they handed their top five executives between 1992 and 2001. See "Fat Options Bad for Business," appearing in *Corporate News Briefs*, November 20 - December 3, 2002, Vol. 4, No. 43 (Portland, Maine: The Corporate Library).
15. Remarks of Marina v.N. Whitman, Professor of Business Administration and Public Policy, University of Michigan, made at "Sustainability + Corporate Governance = Sustainable Governance," the CERES 2003 Annual Conference, on April 2, 2003 in New York City. CERES — the Coalition for Environmentally Responsible Economics — is a Boston-based nonprofit coalition of over 80 investors, public pension trustees, foundations, labor unions, and environmental, religious, and public interest groups; the combined asset value of CERES coalition members is estimated to be \$300 billion. Organized fourteen years ago to promote a comprehensive set of ten environmental principles with which to assess corporate behavior, CERES has evolved from concerns about the impact of the 1989 *Exxon Valdez* oil spill off the coast of Alaska to its current focus on globally sustainable economic activity. Its Sustainable Governance Project joins the sustainability and corporate governance communities in common cause to improve corporate accountability, using the potent tool of liability disclosure, on global warming and other social, environmental, and governance issues. Mindy S. Lubber and Robert Kinloch Massie, long time corporate accountability activists and opinion leaders, are executive director and senior fellow of CERES, respectively. Further information on CERES can be obtained by contacting them at 99 Chauncy Street, 6th Floor, Boston, Massachusetts 02111 or by visiting its website at [www.ceres.org](http://www.ceres.org)
  16. *Business Ethics* email update, July 26, 2003.
  17. See, for example, Arthur Levitt, *Take On the Street: What Wall Street and Corporate America Don't Want You to Know and What You Can Do to Fight Back*, with Paula Dwyer (New York: Pantheon Books, 2002); Barbara Ley Toffler, *Final Accounting: Ambition, Greed, and the Fall of Arthur Andersen*, with Jennifer Reingold (New York: Broadway Books, 2003); Mike Brewster, *Unaccountable: How the Accounting Profession Forfeited a Public Trust* (New York: Wiley, 2003); Frank Partnoy, *Infectious Greed: How Deceit and Risk Corrupted the Financial Markets* (New York: Times Books / Henry Holt & Company, 2003); Mimi Swartz, *Power Failure: The Inside Story of the Collapse of Enron*, with Sherron Watkins (New York: Doubleday, 2003).
  18. See Tatiana Serafin, "Governance Experts Feed Off New Law," Reuters, July 20, 2003.
  19. Statement of Timothy Smith upon release of *2003 Shareholder Proxy Season Overview: Social and Corporate Governance Resolution Trends*, A Report from the Investor Responsibility Research Center (IRRC) and the Interfaith Center on Corporate Responsibility (ICCR), Released by IRRC, ICCR, the Social Investment Forum, and CERES, February 12, 2003. The full report and a streaming audio replay of the news event marking its release is available online at [www.hastingsgroup.com/2003ShareholderSeason.html](http://www.hastingsgroup.com/2003ShareholderSeason.html). The Interfaith Center on Corporate Responsibility is an association of 275 faith-based institutional investors, including national denominations, religious communities, pension funds, endowments, hospital corporations, economic development funds, and publishing companies. For the past 30 years ICCR has been a staunch advocate for corporate social and environmental responsibility; each year its member religious institutional investors sponsor or co-sponsor more than 100 shareholder resolutions on major social and environmental issues. The combined portfolio value of ICCR's member organizations is estimated to be \$110 billion. Further information on ICCR's history and activities can be obtained by visiting its website at [www.iccr.org](http://www.iccr.org). The Social Investment Forum's membership of 500 financial planners, community banks, mutual fund companies, research firms, foundations, and community investing institutions is dedicated to promoting the concept, practice, and growth of socially and environmentally responsible investing. Further information on the Forum can be found at [www.socialinvest.org](http://www.socialinvest.org). Founded in 1975 by the legendary Robert Zevin, Walden Asset Management is the socially responsible investment division of United States Trust Company of Boston. More information on its offerings can be viewed at [www.waldenassetmgmt.com](http://www.waldenassetmgmt.com)
  20. Statement of Mindy Lubber upon release of *2003 Shareholder Proxy Season*

- Overview: Social and Corporate Governance Resolution Trends*, A Report from the Investor Responsibility Research Center (IRRC) and the Interfaith Center on Corporate Responsibility (ICCR), Released by IRRC, ICCR, the Social Investment Forum, and CERES, February 12, 2003. The full report and a streaming audio replay of the news event marking its release is available online at [www.hastingsgroup.com/2003ShareholderSeason.html](http://www.hastingsgroup.com/2003ShareholderSeason.html).
21. See "Report: Top Greenhouse Gas Emitters in Oil, Utility and Auto Industries Not Disclosing, Acting on Financial Risks of Climate Change," Press Release, CERES, July 9, 2003.
  22. Source: Investor Responsibility Research Center. See also Katharine Q. Seelye, "Environmental Groups Gain as Companies Vote on Issues," the *New York Times*, May 29, 2003. According to Meg Voorhes, director of IRRC's Social Issues Service and a longtime chronicler and expert on shareholder activism and corporate social responsibility, "In the 32-year history of shareholder activism on social issues, only board diversity proposals have had average support levels topping 20 percent. What we're seeing with these vote results creeping up is that people are saying maybe there is something to this idea that global climate change is a risk and the companies aren't preparing for it, they aren't discussing it forthrightly or in detail."
  23. For an elaboration on this, see Marcy Murningham, *Money and Morality: Cultivating a Civic Stewardship Ethic*, A Report to The Boston Foundation, with assistance from Mary Naber and KLD Research & Analytics, Inc. (Boston: December 1999). See also Murningham, *Corporate Civic Responsibility and the Ownership Agenda: Investing in the Public Good*. An excellent and detailed treatment of the new corporate ownership regime and the opportunities for constructive action can be found in Robert A.G. Monks, *The New Global Investors: How Shareowners Can Unlock Sustainable Prosperity Worldwide* (Oxford, U.K.: Capstone Publishing Limited [A Wiley Company], 2001). See also James P. Hawley and Andrew T. Williams, *The Rise of Fiduciary Capitalism: How Institutional Investors Can Make Corporate America More Democratic* (Philadelphia: University of Pennsylvania Press, 2000), a superbly comprehensive treatment of the transformation of fiduciary institutions into "universal owners" and the implications of this transformation on wider economic efficiencies. On the matter of the corporate ownership role in equity value creation, see also Rolf H. Carlsson, *Ownership and Value Creation: Strategic Corporate Governance in the New Economy* (Chichester, U.K.: John Wiley & Sons, Inc., 2001) and the path breaking work of Jonathan Charkham and Anne Simpson, *Fair Shares: The Future of Shareholder Power and Responsibility* (Oxford: Oxford University Press, 1999).  
24. See especially Robert A.G. Monks and Nell Minow, *Power and Accountability* (New York: HarperCollins Publishers, Inc., 1991.) As recently reported in *Barron's*, back in 1988, Nicholas H.S. Higgins, president of Ram Trust Services, a Portland, Me., investment adviser, sought the SEC's guidance for his firm's "role with regard to proxies" for stocks in accounts it ran. Higgins' letter, which also touched on mutual funds, wasn't answered. The letter was inspired by his uncle, Robert A.G. Monks, co-founder of Institutional Shareholder Services, which provides proxy research and voting advice to institutional investors. Another high-profile supporter was Nell Minow. The letter remained unanswered for almost 15 years until the AFL-CIO, Teamsters, and Domini Social Investments petitioned the SEC in 2000 and 2001 to require proxy disclosure which, they argued, would enhance corporate governance, prevent conflicts of interest by investment managers who run retirement plans, and ensure that the funds' votes reflect the best interests of the shareholders. See Werner Renberg, "Parting the Curtain," *Barron's*, April 7, 2003. Another excellent repository of all matters related to corporate governance is the website devoted to Bob Monks' work, which is [www.ragm.com](http://www.ragm.com). See also The Corporate Library, organized by Monks and Minow, at [www.thecorporatelibrary.com](http://www.thecorporatelibrary.com)
  25. See *Harvard College v. Amory*, 26 Mass. (9 Pick.) 446, 461 (1830). In this case, which involved the duty of a trustee with respect to the investment of trust funds, the Massachusetts Supreme Judicial Court determined that trustees have two basic duties: (1) to invest prudently, thus assuring maximum return on and safety of the trust assets, and (2) undivided loyalty to the beneficiaries of the trust. The prudent man standard represented in the *Harvard College* case, which provided for flexibility and ongoing modification, did not receive widespread acceptance outside of Massachusetts until the 1940s.

26. Aristotle, *Politics*, Book 1 provides an introduction to his analysis of the *polis* and is primarily devoted to a discussion of *oikonomia*, the art of household management or home economics. Aristotle, "The Theory of the Household," in *The Politics of Aristotle*, bk. 1 trans. and ed. Ernest Barker (New York: Oxford University Press, 1946). See also William James Booth for a superb exposition of the Aristotelian conception of the household (in addition to the classic liberal and Marxist interpretation), the most fundamental economic unit, and its significance to our times in *Households: On the Moral Architecture of the Economy* (Ithaca: Cornell University Press, 1993).
27. Anthony Everitt, *Cicero: The Life and Times of Rome's Greatest Politician* (New York: Random House, 2001): 24-25.
28. Before her death in 1992, Judith Shklar invigorated our understanding of American politics and government with her trenchant insights into the contradictions between official claims of equal citizenship and the reality experienced by most who were denied it. In *American Citizenship: The Quest for Inclusion*, she moves beyond three other distinct meanings of citizenship (including active participation or "good" citizenship, ideal republican citizenship, and "citizenship as nationality," a legal recognition accompanied by various social exclusions and inclusions, "in which xenophobia, racism, religious bigotry, and fear of alien conspiracies have played their part") and introduces the concept of "citizenship as public standing," manifest by its two "great emblems": the vote and the opportunity to earn a living. The American Constitution does not mention citizenship at all until the Fourteenth Amendment, but Americans had quite clear ideas about what the social meaning of citizenship was, and when they were denied it, they protested....What has been continuous is a series of conflicts arising from enduring anti-liberal dispositions that have regularly asserted themselves, often very successfully, against the promise of equal political rights contained in the Declaration of Independence and its successors, the three Civil War amendments. It is because slavery, racism, nativism, and sexism, often institutionalized in exclusionary and discriminatory laws and practices, have been and still are arrayed against the officially accepted claims of equal citizenship that there is a real pattern to be discerned in the tortuous development of American ideas of citizenship. If there is permanence here, it is one of lasting conflicting claims." See Judith Shklar, *American Citizenship: The Quest for Inclusion*, The Tanner Lectures on Human Values (Cambridge and London: Harvard University Press, 1991), 2, 13-15.
29. Robert A.G. Monks, "Equity Culture at Risk," *European Business Forum*, Issue 12, Winter 2002/03. This article was adapted from a speech given to the 5th International Conference on Corporate Governance and Direction at Henley Management College in October 2002, and can be viewed at [www.ebfonline.com](http://www.ebfonline.com) or at [www.ragm.com](http://www.ragm.com). In it, Monks traces the evolution of what he calls "the triumph of excess," particularly concerning executive compensation. He also proposes that governments affirm that an effective shareholder presence in all companies is in the national interest; that all pension fund trustees and other fiduciaries act solely in the long-term interest of their beneficiaries; that institutional shareholders should be made accountable for exercising their votes in an informed and sensible manner above some sensibly determined minimum holding; and that shareholders have the exclusive right and obligation to nominate at least three non-executive directors to corporate boards.
30. Theda Skocpol, *Diminished Democracy: From Membership to Management in American Civic Life*, The Julian J. Rothbaum Distinguished Lecture Series, vol. 8 (Norman, Oklahoma: University of Oklahoma Press, 2003), 12, 13.
31. The American public, liberals and conservatives alike, have often displayed deeply contradictory attitudes about the relationship between religion and politics. A 2001 Gallup Poll found that 82 percent of Americans thought of themselves as Christians, 10 percent belonged to other faiths and 8 percent were atheists or agnostics. But poll respondents also said no dogma, religious creed, or denominational commitment guided their beliefs. For further information on Gallup survey analysis of American attitudes concerning religion and values, see [www.gallup.com](http://www.gallup.com).
32. Skocpol, *Diminished Democracy*, 264-265.
33. *Ibid.*, 291-293.
34. Voter registration and turnout in Presidential elections have declined since 1960, when 62.77 percent of eligible voters exercised their franchise, according to the

- FEC. In 1964, the turnout figures were 61.92 percent; in 1968, 60.84 percent; in 1972, 55.21 percent; in 1976, 53.55 percent; in 1980, 52.56 percent; in 1984, 53.11 percent; in 1988, 50.15 percent; in 1992, 55.23 percent; and in 1996, the first time since the 1920s, less than half of the eligible voting population turned out to vote, with 49.08 percent doing so. For this and other information, visit the Federal Election Commission's website at [www.fec.gov](http://www.fec.gov).
35. Thomas E. Patterson, *The Vanishing Voter: Public Involvement in a Time of Uncertainty* (New York: Alfred A. Knopf, 2002), Chapter One. Over the past 40 years, voter apathy has increased to a level that is, according to Patterson, "dangerous for democracy." A survey research project of the Joan Shorenstein Center on the Press, Politics and Public Policy, and funded by the Pew Charitable Trusts, the Vanishing Voter Project conducted weekly interviews with 80,000 Americans. What the researchers found was a great deal of voter apathy and disinterest regarding politics and self-government. "The United States had 100 million fewer people in 1960 than it did in 2000 but, even so, more viewers tuned to the October presidential debates in 1960 than did so in 2000," Patterson writes. Chief among the culprits he identifies: the parties have declined in influence; the press dwells too much on the negative; the presidential campaigns go for so long that they send voters "on a mind-numbing trek"; it is too difficult for people to register to vote in many states. Patterson's solution: shorten the presidential nomination process. He would have no more than five state contests, held a week or two apart, followed a month later by the remaining 45 states conducting what would amount to a national primary. What about the absence of galvanizing issues, or the need for better candidates? Patterson acknowledges that these would help matters; one major cause of voter apathy could be that people "do not believe the candidates are very worthy of respect." For more on the Vanishing Voter Project, see its website at [www.vanishingvoter@ksg.harvard.edu](http://www.vanishingvoter@ksg.harvard.edu).
  36. See Gregory Zuckerman and Ruth Simon, "How Should States Use Money?" *The Wall Street Journal*, May 2, 2003. Information taken from a special *Wall Street Journal* news roundup, "Regulators Unveil Settlement With Landmark Fines, Reforms," appearing on *The Wall Street Journal Online*, April 28, 2003. See also David Stout, "Regulators Reach Final Settlement Against Wall Street Firms," *New York Times*, April 28, 2003. Detailed provisions of the enforcement action and subsequent rulemaking can be read on the SEC's website at [www.sec.gov](http://www.sec.gov).
  37. See "SEC Defends \$1.4 B Wall Street Settlement," *New York Times*, 17 June 2003.
  38. In addition to a national distribution network, state securities regulators are expected to launch various programs designed to help educate investors, and state and local officials are expected to begin asking questions of public fund executives about their intentions to mitigate risk and increase shareholder diligence and engagement. The author currently is involved with some of these initiatives. Further help on how to get started can be obtained from Steven D. Lydenberg and Joe Keefe, *Corporate Governance and Social Responsibility: A Handbook for State Treasurers and Legislators* (New York: Domini Social Investments, LLC, forthcoming).
  39. The wee hours of October 22, 1999, the nation's financial system was truly transformed, a formality that followed years of corporate consolidation and the rise of the global economy. After decades of trying and some last-minute partisan bickering between politicians in Congress and the White House over provisions of the Community Reinvestment Act, the 66-year-old Glass-Steagall Act, which enforced a separation between commercial and investment banks, was repealed. Created in response to the stock market crash of October 1929 and the ensuing Great Depression, the Glass-Steagall Banking Reform Act, signed into law by Franklin D. Roosevelt on June 17, 1933, prohibited banks, investment banks, and insurance companies from entering into each other's business. We seem to have come full circle as yet another policy "remedy" seems to have contributed to current policy failures.
  40. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).
  41. Charles Elson, who has distinguished himself as an expert on corporate governance and the duties of boards and is the director of the University of Delaware business college's Weinberg Center for Corporate Governance, recently quipped that "boards are like an appendix you don't quite know what they're there for until they become

- infected.” Elson, along with NYU law professor Jeremy Weisen, corporate governance champion Robert Monks, and corporate reputation expert Alan Tower (who distinguishes corporate reputation management from corporate public relations, “because it’s not about spin, it’s about managing the intangible and the congruence between a company’s culture, values, and performance”), were featured speakers at a March 2003 gathering of the Coudert Institute in Palm Beach, Florida. The two-day program on *Restoring the Confidence of American Investors in Equity Securities* was held March 7-8, 2003. The Coudert Institute is a registered §501 (c) (3) non-profit corporation founded in 1999 by Dale Coudert, intellectual activist, realtor, and former director / officer of the First Women’s Bank in New York. The Coudert Institute was established by a group of civic-minded individuals in Palm Beach to provide a forum for reflective dialogue, affording present and future leaders the opportunity to present their ethical visions and to communicate the need for action. Further information on the Coudert Institute and its offerings can be obtained by visiting its website at [www.coudertinstitute.org](http://www.coudertinstitute.org).
42. The five-member Public Company Accounting Oversight Board had an inauspicious start with former SEC commissioner Harvey Pitt’s disastrous attempt last fall to appoint former CIA head William Webster. William Donaldson, Pitt’s replacement and current SEC chairman, announced on April 15, 2003 that the job would go to William McDonough instead. “The task before us is to restore the confidence of the American people and others around the world” that audited financial statements “present a complete, true and timely report that can be relied on,” McDonough said in Washington, shortly after his appointment. See Floyd Norris, “S.E.C. Picks a Fed Banker to Lead Panel,” *New York Times*, April 16, 2003.
  43. Jeremy Wiesen, “Congress Enacts Sarbanes-Oxley Act of 2002: A Two-Ton Gorilla Awakes and Speaks,” 1-2. Wiesen’s clear and timely analysis was presented at the Coudert Institute program on *Restoring the Confidence of American Investors in Equity Securities*, held in Palm Beach on March 7-8, 2003; he is associate professor of business law and accounting at the Leonard N. Stern School of Business at New York University, and was Special Assistant to the SEC’s Disclosure Study Group. Most of the citations in this article regarding Sarbanes-Oxley are taken from Weisen’s work, for which the author is immensely grateful.
  44. Sarbanes-Oxley Act § 301.
  45. Sarbanes-Oxley Act § 307.
  46. 17 CFR 240.16b.
  47. Sarbanes-Oxley Act § 301.
  48. Sarbanes-Oxley Act § 303(a).
  49. Sarbanes-Oxley Act § 406.
  50. This is consistent with the SEC’s “Plain English Release” requiring the use of plain English disclosure principles. See Securities Act Release No. 7497 (January 28, 1998) (63 FR 6370).
  51. Sarbanes-Oxley Act § 406(b).
  52. Sarbanes-Oxley Act § 501(a).
  53. Sarbanes-Oxley Act § 301 and 1107.
  54. Sarbanes-Oxley Act § 108(d), 704, 401(c)(1), 702 and 704.
  55. Statement of Nell Minow to the Corporate Accountability and Listing Standards Committee, New York Stock Exchange, April 15, 2003. One of the most intelligent and eloquent leaders in the push for corporate accountability, Nell Minow — long-time partner of the equally gifted Bob Monks, and custodian of cultural values in a second role as “Movie Mom,” a critic of family-oriented films with a syndicated column and book under her belt — is the editor of *The Corporate Library*, a Portland, Maine based corporate governance research and monitoring group that she co-founded with Monks in 1999. Dubbed by *Fortune* magazine as a “CEO killer,” Minow is a popular media commentator on the causes and consequences of corporate corruption. A copy of this and other public testimony and speeches by Nell Minow can be viewed by visiting *The Corporate Library* website at [www.thecorporatelibrary.com](http://www.thecorporatelibrary.com). Her work as “Movie Mom” appears in *The Movie Mom’s Guide to Family Movies* (now in its fourth printing), and at [www.moviemom.com](http://www.moviemom.com).
  56. Monks interview.



57. See Patrick McGeehan, "Change Sweeps Big Board: Chief's Pay to Be Revealed," *New York Times*, June 6, 2003.
58. *Ibid.*
59. Critics have focused on NYSE chairman Richard Grasso and his relationship with Kenneth Langone, founder of Home Depot. Langone and Grasso serve as directors on the boards of both Home Depot and the NYSE. Langone, a member of the NYSE corporate governance committee, also serves as chairman of the exchange's compensation committee, which granted Grasso a \$10 million annual compensation package. Meanwhile, Grasso serves as chairman of the Home Depot compensation committee, as well as its nominating and corporate governance committee. See David Weidner, "Grappling with governance: NYSE mulls hearings amid criticism of Grasso ties," *CBS MarketWatch*, May 27, 2003. Ongoing developments related to the NYSE governance controversy are regularly reported on The Corporate Library's website.
60. See "American Stock Exchange Approves Enhanced Governance Framework," appearing in *Corporate News Briefs*, November 20 - December 3, 2002, Vol. 4, No. 43 (Portland, Maine: The Corporate Library).
61. Interview with Richard F. Syron, December 17, 2002.
62. According to a March 2003 dispatch carried over Dow Jones Newswires, "The Sarbanes-Oxley act may have touched off changes in controls and compliance practices at 85 percent of large US corporations, but only a third of executives at those companies believe the new law will restore investor confidence or help their companies create shareholder value, according to a study by PricewaterhouseCoopers. Only 9 percent of executives called Sarbanes-Oxley a "good response" to recent accounting scandals. Among the survey's findings: 42 percent believe the Act will impose unnecessary costs on companies; 15 percent said it was ill-conceived and hastily passed; 33 percent said the law was a good first step but more needs to be done; 82 percent of executives expressed confidence that their companies are in full compliance with law's provisions; 31 percent said Sarbanes-Oxley will bolster investor confidence, with 3 percent anticipating significant influence, 19 percent seeing moderate impact, and nearly half saying that there would be no direct impact; and, 56 percent said the law will have a neutral effect on shareholder value, while 32 percent see a positive impact, and 6 percent said negative impact. While only 3 percent said compliance has been very costly, 71 percent expect compliance costs to increase over the long term. Concerning the requirement that CEOs and chief financial officers certify their financials, 65 percent said the rule represents an increased risk for executives, 17 percent said the risk is much higher, and 32 percent don't see any change in risk." See "Only 33% Of Execs See Sarbanes-Oxley Restoring Confidence," Dow Jones Newswires, March 24, 2003, appearing in *Corporate News Briefs*, March 19 - March 25, 2003 Vol. 5, No. 11 (Portland, Maine: The Corporate Library).
63. Contrary to what it described as "very limited independent board leadership" on the S&P 1500, the IRRRC's 144-page report said progress is in fact being made. "Despite some spectacular corporate failures, this year's analysis reveals that companies generally continued to implement practices commonly associated with good governance, including record levels of companies with majority independent boards and an increase in the independence of audit committees," said the IRRRC. See "U.S. Companies Behind on Governance Rules," appearing in *Corporate News Briefs*, November 20 - December 3, 2002, Vol. 4, No. 43 (Portland, Maine: The Corporate Library).
64. The rules of the new governance regime are already changing behavior, but not necessarily in ways that were expected. *Corporate Financing Week*, a newsletter on capital markets for corporate executives and investment bankers published by Institutional Investor, Inc., reported in late April 2003 that smaller investment banks are getting into the board advisory service business to help directors better understand finance as well as respond to fear of liability; they believe they are well suited to this as larger banks have too many conflicts of interest that working with a board creates. See Liz Rappaport, "Firms Make Push into Lucrative Board Advisory Services," *Corporate Financing Week*, April 30, 2003. *Corporate Financing Week* also reported that a survey of 5,000 directors of corporate boards revealed that 31.5 percent of inside directors and 18.5 percent of outside directors would turn down a new seat because of increased responsibility and the liability that comes with it. Approx-

mately 88 percent of those surveyed cited the Sarbanes-Oxley Act, 72 percent cited exchange listing requirements, and 82 percent cited corporate governance scandals as the primary reasons. See "New Regs Keep Execs Leery of Joining Boards," *Corporate Financing Week*, April 30, 2003. Last November, the New York Stock Exchange (NYSE) said it expected to set a new record for disciplining executives, directors, traders, brokers, and other market participants as regulators crack down on US corporate culture in the wake of Enron and WorldCom. Throughout 2002, the NYSE levied fines or suspended executives more than 200 times, and expected by the end of the year to beat the 2001 record of 236. In the year ending in September, the Securities and Exchange Commission (SEC) had filed 598 enforcement actions, beating the 484 actions taken in 2001. The SEC also moved to bar some 126 corporate officers, more than double 2001's number. In 2002, the NYSE imposed nearly \$250,000 in fines in 700 cases against listed firms. Also, late last October 2002, *The Financial Times* reported that a growing number of small companies listed on US stock exchanges are considering delisting and going private in order to avoid the recent Sarbanes-Oxley disclosure and governance regulations. One cause for concern among smaller firms is that they would have to repopulate their boards with independent directors, which would significantly increase the number of directors at companies at the same time that insurers are raising premiums on protection on director liability, and would leave small companies unable to shoulder the expense.

65. See "Study Suggests Most Big Companies Will Have to Make Changes," Dow Jones Newswires, November 8, 2002, reported in *Corporate News Briefs*, November 20 - December 3, 2002, Vol. 4, No. 43 (Portland, Maine: The Corporate Library). For 30 years, the highly regarded Washington-based Investor Responsibility Research Center ("IRRC") has reported on proxy voting in the U.S. and throughout the world, as well as other business issues affecting corporations and investors. IRRC offers research, software, and advisory services on a variety of topics, including corporate governance, human rights, labor issues, corporate environmental performance, Northern Ireland, Burma, and tobacco companies. In addition to its portfolio screening services, IRRC also provides corporate monitoring services, including corporate environmental profiles, corporate activity in Northern Ireland, and information services regarding Burma, Iran, and tobacco. IRRC offers an impressive line of proxy voting services, from "total outsourcing solutions" to consulting, software, research and other tools to help investors manage the voting process, including international proxy voting. A new IRRC offering is "Global Security Risk Monitor," the world's first global security risk profile and assessment product in the areas of terrorism and weapons proliferation. The Global Security Risk Monitor will profile domestic and foreign companies whose global activities may pose material international security-related risks to investors. Further information on IRRC, its history, and its services can be obtained by visiting its website at [www.irrc.org](http://www.irrc.org).
66. See Alan Murray, "Fight With Spitzer Over Bill Is No-Win Situation for SEC," *The Wall Street Journal*, July 22, 2003, and Randall Smith and Deborah Solomon, "State-Level Stock Cops Retain Power," *The Wall Street Journal*, July 25, 2003.
67. Launched in 1997 as a joint initiative of CERES and the United Nations Environment Programme with the goal of enhancing the quality, rigor, and utility of sustainability reporting, the GRI involves active support and engagement of representatives from business, nonprofit advocacy groups, accounting firms, investor organizations, trade unions, and other institutions. Following an intense worldwide process of consultation and consensus building, in 2002 the Global Reporting Initiative released the *2002 Sustainability Reporting Guidelines* at the Johannesburg World Summit. (According to the *Guidelines*, "GRI uses the term 'sustainability reporting' synonymously with citizenship reporting, social reporting, triple-bottom line reporting, and other terms that encompass the economic, environmental, and social aspects of an organization's performance.") Considered a "work in progress," the *2002 Guidelines* provide a framework for corporate, governmental, and nongovernmental organizations to use for voluntarily reporting on the economic, environmental, and social dimensions of their activities, products, and services. With its permanent Secretariat now based in Amsterdam, GRI intends to continually revise, improve, and update its guidelines, technical protocols, and sector supplements, while preserving their multi-stakeholder

- process of collaboration and transparency. See Global Reporting Initiative, *2002 Sustainability Reporting Guidelines* (Amsterdam, Netherlands: Global Reporting Initiative, 2002), which can be obtained by visiting the GRI website at [www.globalreporting.org](http://www.globalreporting.org)
68. Atwood's initiative, which was co-sponsored by the Environmental Media Association, the Investors' Circle, and a number of other corporate and nonprofit groups, gathered more than 240 creative experts and funders for a three-day series of discussions and workshops on how to transform the media industry. Central to the agenda was the production, marketing, and distribution of "social mission media," meaning films and television shows that have cross-cultural social and environmental themes dedicated to supporting and improving society. The Sundance conference was a success and has led to multiple spin-offs, including a special investment fund, currently in development, that will underwrite the production and distribution of high-quality media properties, designed specifically for institutional investors. Further information on the Sundance conference and its progeny can be obtained by visiting the website at [www.spartacusmedia.com](http://www.spartacusmedia.com).
  69. According to governance expert Charles Elson, shareholder claims not only have driven up the cost of liability insurance premiums, but also, in some cases, have exceeded them. Few insurance companies can survive when they are paying more in claims than they receive in premiums. Referring to AIG, one of the toughest insurance companies around, selling director and officer liability insurance "is not a viable business given the claims that are out there. I guess at some point we've got to re-think, not the insurance system, but the legal system." Remarks made at Coudert Institute, March 2003.
  70. See Peter Dobkin Hall, *A History of Nonprofit Boards in the United States*, Research in Action Series (Washington, D.C.: National Center for Nonprofit Boards, 1997). NCNB's Research in Action series has been underwritten with support from the Andrew W. Mellon Foundation. Hall's essay chronicles the shifting tensions between political and religious as well as public and private power throughout our nation's history.
  71. The National Association of Corporate Directors was founded in 1977 and is a prominent educational, publishing, and consulting organization on board leadership; it also is the only membership association for boards, directors, director-candidates, and board advisors. Its mission is to be "an authoritative voice and vital forum on matters of policy and practice." NACD promotes high professional board standards, creates forums for peer interaction, enhances director effectiveness, asserts the policy interests of directors, conducts research, and educates boards and directors concerning traditional and cutting-edge issues. Further information on the NACD can be obtained by contacting it at 1828 L Street, NW Suite 801, Washington, D.C. 20036 or visiting its website at [www.nacdonline.org](http://www.nacdonline.org).
  72. Presentation on "Director Fiduciary Duties and Climate Change," made at "Sustainability + Corporate Governance = Sustainable Governance," the CERES 2003 Annual Conference on April 1, 2003 in New York City. Ms. Gregory counsels corporate directors, trustees, managers, and institutional investors on a range of governance issues, including director and trustee responsibilities, conflicts of interest, board and committee structure, board audits and self-evaluation processes, institutional investor initiatives, and international governance "best practice." In the public policy arena, Ms. Gregory has worked with the legendary Ira M. Millstein in various projects for the OECD, the World Bank, the European Commission, and the U.S. Securities and Exchange Commission, related to corporate governance. She has helped organize corporate governance programs for the OECD, the World Bank, Transparency International, the SEC, and Columbia University School of Law's Institutional Investor Project.
  73. Source: Investment Company Institute, 2003.
  74. Domini Social Investments ("DSI") is one of the world's leading money managers, and specializes in socially responsible investing. Founded in 1990 by Amy Domini, DSI now manages \$1.3 billion in institutional and individual assets for those wanting to incorporate social and environmental criteria into their investment decision making. Included in its product line are the Domini Social Equity Fund, the world's oldest and largest socially responsible index fund, as well as two vehicles that invest in

community economic development, the Domini Social Bond Fund and the Domini Money Market Account. Amy Domini and her partners Peter Kinder and Steve Lydenberg are pioneers and leading lights in the burgeoning social investing movement and take their leadership and public education roles very seriously; they also perform them very well. In 1989, they began work on the Domini 400 Social Index, an index of 400 primarily large-capitalization U.S. corporations, roughly comparable to the S&P 500, selected based on a wide range of social and environmental criteria. When it was launched in 1990, it was the first index of its kind. A year later, they launched the Domini Social Equity Fund to provide investors with a fund that tracks the Index. At the same time, they launched KLD Research & Analytics, Inc. (formerly Kinder, Lydenberg, Domini & Co.), a firm dedicated to providing social, environmental, and corporate governance research on publicly traded corporations, information that at that time was not being systematically collected. The ten-year track record of the Domini 400 Social Index has proven that social and environmental screens do not limit financial performance. To the contrary, they may, in fact, lead to higher returns. Domini has written, co-written, or edited several books, including *Ethical Investing* (Addison-Wesley, 1984); *Challenges of Wealth* (Dow Jones Irwin, 1988); *The Social Investment Almanac*, with other contributors (Henry Holt & Co., 1992) and *Investing for Good* (Harper Collins, 1993), a guide for socially responsible investors. Her most recent book, *Socially Responsible Investing: Making a Difference and Making Money* (Dearborn Trade) was published in early 2001. She is a frequent guest commentator on CNBC's *Talking Stocks* and various other radio and television shows. Further information on Domini & Co., including many of the books, monographs, and essays they have authored as well as links to advocacy groups and other resources, can be found by visiting [www.domini.com](http://www.domini.com).

75. See John J. Brennan and Edward C. Johnson 3rd, "No Disclosure: The Feeling is Mutual," *The Wall Street Journal*, January 14, 2003. "While it seems a well-intended effort to restore investor confidence in corporate America and promote accountability, the proposal's unintended consequences could undermine the best interests of 95 million mutual-fund shareholders in the U.S.," the authors claim. "In case after case, it would open mutual-fund voting decisions to thinly veiled intimidation from activist groups whose agendas may have nothing to do with maximizing our clients' returns." After the SEC decision, the Investment Company Institute issued a statement supporting many of the proxy voting proposals, but asserted that, "a critical part of the rule overreaches, and is more likely to harm than help fund shareholders. It will produce no additional benefits while encouraging the politicization of mutual fund portfolio management." See "ICI Issues Statement on SEC Proxy Vote Disclosure Rule," Investment Company Institute, Washington, D.C., January 23, 2003.
76. TIAA-CREF, one of the nation's largest financial services organizations with \$262 billion in assets under management, is widely recognized as a major voice for shareholder rights and improved corporate governance and takes its ownership responsibilities very seriously, which is why the TIAA-CREF stance puzzled many observers. According to reports published in *Corporate News Briefs*, last November TIAA-CREF chairman and chief executive Herbert Allison Jr. announced his opposition to the SEC proposal requiring pension funds to disclose how they vote on proxies at corporate annual meetings. Participants in TIAA-CREF's investment unit rejected a shareholder proposal to disclose the fund's proxy votes, with 76.5 percent against and 18.7 percent in favor. Allison said the SEC proposal would likely expose shareholders to pressure from corporate management. "We have concerns about preserving the confidentiality of all shareholder votes so certain shareholders are not brought under undue pressure," he said. "We are also concerned that our votes could be misunderstood, because often we are sympathetic to an issue but the wording could make it impractical. So just seeing the way we voted may not reflect our management." Allison went on to say that such disclosure would be impractical for the fund due to the volume of proxies it votes on, and said such votes are often based on confidential information. "We feel quiet diplomacy often is more effective than a public disclosure," he said. See "Pension Fund Leader Opposes SEC Disclosure Proposal" appearing in *Corporate News Briefs*, November 20 - December 3, 2002, Vol. 4, No. 43 (Portland, Maine: The Corporate Library).
77. For important work on the relevance of intangible assets to corporate governance

- and performance, see especially the work of Georgetown University's Margaret Blair. *Ownership and Control: Rethinking Corporate Governance for the Twenty-first Century*
78. On February 23, 1988, the Department of Labor issued an interpretive ruling to Avon Products, Inc., which mandated proxy voting on the part of all ERISA (that is, corporate retirement) funds. The so-called Avon letter stated that, "In general, the fiduciary act of managing plan assets which are shares of corporate stock would include the voting of proxies appurtenant to those shares of stock." See *Interpretive Bulletin 94 — 2* Title 29 (Washington, D.C.: U.S. Government Printing Office, 1994), 38860.
79. See John C. Bogle, "Mutual Fund Secrecy," *New York Times*, December 14, 2002. In 1999, Bogle called mutual funds "the controlling force in corporate America." He also sharply criticized the industry for neglecting "to live up to their responsibility of corporate citizenship," particularly because they failed to use their proxy voting power to oppose management on issues such as excessive stock-option issuance, option repricing, and earnings that are distorted by accounting gimmicks. In a speech to the Investment Company Institute, a prominent mutual fund professional association, Bogle called for the ICI to take the lead in promoting corporate governance as an issue, perhaps through a roundtable or forum. He praised the efforts of state and local pension funds and TIAA-CREF in doing so, and noted that Vanguard had a staff of five that reviews proxies and regularly votes against management initiatives such as stock-option plans viewed as heavily dilutive to existing shareholders, as well as certain types of anti-takeover corporate defenses. After Fidelity, Vanguard Group is the second largest mutual fund company in the world, with \$500 billion in assets under management. See Robert McGough and Pui-Wing Tam, "Fund Track: Bogle Urges Role in Corporate Governance," *The Wall Street Journal*, October 21, 1999.
80. See John C. Bogle, "The Emperor's New Mutual Funds," *The Wall Street Journal*, July 8, 2003.
81. Atkins' reference to "refereeing" concerns the SEC's role in vetting proposed proxy resolutions before they are submitted to shareholders. "There is an inordinate amount of resources, both public and private, that is devoted each year to determining whether proposals may be excluded from the shareholder proxy statement," he told the CII membership, and talked specifically about the most commonly used of the thirteen exclusionary criteria the SEC uses to determine eligibility on the corporate annual meeting ballot. The most frequently cited is the "ordinary business" exclusion, intended to apply to mundane business matters. According to SEC Rule 14a-8(c)(7), proposals that are considered part of a company's "ordinary business" operations can be excluded on the grounds that management, rather than shareholders, should decide; this rule evolved after the SEC allowed Greyhound to omit a 1946 resolution that would abolish segregated seating on buses on the grounds that the rule enabling shareholders to file proxy proposals was not intended to permit proposals of a general political, social, or economic nature. The "ordinary business" clause has been disputed ever since. However, former SEC chairman Harvey L. Pitt proposed at a fall 2002 meeting of the Council of Institutional Investors that the SEC consider eliminating the ordinary business exception. Democratic commissioners have made similar proposals, in 1982 and 1996, but they were not supported. For further information on recent public criticism of the SEC role in reviewing proxy resolutions, see "SEC to Revisit Shareholder Proposal Rule," *IRRC Industry News*, April — May 2003 (Washington, D.C.: Investor Responsibility Research Center), or visit its website at [www.irrc.com](http://www.irrc.com). As described in its promotional material, the Council of Institutional Investors is an organization of large public, labor, and corporate pension funds formed to address investment issues, particularly corporate governance, that affect "the size and security of plan assets." Its objectives are to encourage member funds, as major shareholders, to take an active role in protecting plan assets and to help members increase rates of return on their investments as part of their fiduciary obligation. Founded in 1985 as a response to controversial takeover activities that threatened the interests of pension fund beneficiaries, the group began with 20 member funds, led by Jesse M. Unruh, California's treasurer. CII's relatively nuanced profile belies its origins and first two years, which were fueled by Unruh's energy and passion. Unruh was a former speaker of the California state assembly who ran for governor in

- 1970 but lost to Ronald Reagan; he was a colorful figure in politics and finance with an expansionist view of his stewardship role. He died of cancer in 1987. Today, the Council membership includes more than 130 pension funds, with combined assets exceeding \$2 trillion; in addition are more than 125 "honorary international participants and educational sustainers." Sarah Teslik is its longtime executive director. Further information on the CII, including its corporate governance policies and initiatives, can be obtained by visiting its website at [www.cii.org](http://www.cii.org).
82. The April 14 announcement was triggered by a unanimous vote of SEC commissioners on the matter of shareholder-nominated candidates to corporate boards of directors. A number of shareholder proposals filed by the American Federation of State, County, and Municipal Employees ("AFSCME") to Citigroup, AOL Time Warner, Sears, Roebuck, Bank of New York, Exxon Mobil, and Eastman Kodak asked companies to permit a shareholder or group of shareholders owning at least 3 percent of outstanding common shares to nominate one candidate for election to the companies' board of directors and have such candidates included in the companies' proxy materials. The SEC staff decision was to omit these proposals, on the grounds that a company can exclude proposals if they relate to an election for membership on the company's board or other governing body. This unleashed a chorus of opposition from AFSCME, the Council of Institutional Investors, and a number of major institutional investors, including the \$130 billion California Public Employees' Retirement System ("CalPERS") and the New York City Comptroller's Office, which urged the SEC commissioners to reconsider and overturn the staff decision. Further timely information on this and other developments on shareholder activism and the SEC can be obtained from *IRRC Industry News*, a publication of the Investor Responsibility Research Center, at [www.irrc.com](http://www.irrc.com)
83. The AFL-CIO and International Brotherhood of Teamsters ("IBT") pension funds are so-called Taft-Hartley funds, as distinct from employer-sponsored or company funds. Taft-Hartley funds (named for the Taft-Hartley Act that created them) are portable pension funds that typically cover workers in a given industry across company lines, such as those representing carpenters, service employees, teamsters, and so forth. In the past few years, Taft-Hartley funds, with combined assets of more than \$400 billion, have become among the most active and effective of institutional investors. The umbrella organization for 68 unions representing 13.1 million workers across the country, the AFL-CIO is one of the most prominent. Led by Bill Patterson, director of the AFL-CIO Office of Investment, the Capital Stewardship Network was created to coordinate various campaigns among 10,000 capital stewards from unions, public, Taft-Hartley, and private pension plans. The Capital Stewardship Network focuses on proxy voting, public policy advocacy before public agencies such as the SEC and the Department of Labor, corporate governance, and the proxy performance of money managers. For the past five years the union has conducted a survey among its money managers on how they voted on 30 to 40 proxy proposals in accordance with worker-owner principles; its *Key Votes Survey* then grades and ranks these managers and publishes results on its website. Because of the recent SEC directive to mutual funds, the *Key Votes Survey* will now include fund companies in their rating scheme. (Last July, the AFL-CIO canceled a protest march to Fidelity Investments' headquarters after Fidelity officials agreed to meet and discuss the union's call for Fidelity to start making its proxy votes available to the public.) Further information on the AFL-CIO's Capital Stewardship program can be obtained at [www.aflcio.org/corporateamerica/capital.html](http://www.aflcio.org/corporateamerica/capital.html). Demonstrating the potential power of democracy online, Domini Social Investments reports that more than 2,500 comment letters and emails were sent to the SEC by shareholders and friends of Domini, who responded to their email action alert and used their form letter urging support.
84. See Stan Wilson, "ICI Seen Asking SEC to Head Off Hill Fund Legislation," in *Fund Action*, July 2, 2003. At a House hearing held on June 18, the Investment Company Institute stated its commitment to trying to persuade the SEC board of governors to adopt three changes that meet the intent of proposed legislation —including Sarbanes-Oxley audit committee standards for funds, exclusion of advisor relatives or business partners from independent director seats on fund boards, and independent directors occupying two-thirds of board seats — rather than "being blitzed by thunderbolts from Congress."

85. See Gretchen Morgenson, "Plan Restricting Stock Options Stalls at S.E.C.," *New York Times*, March 13, 2003.
86. A survey of 200 companies by Pearl Meyer & Partners, an executive pay consulting firm in New York, found that most companies continued to give out options, with more than 40 percent of the companies giving a larger number of options than in previous years. The *New York Times* reports that the interests of shareholders and executives continue to be nonaligned: The trend still seems to be toward rewarding executives regardless of the performance of their companies, even if there are fewer exceptionally large — meaning options worth more than \$50 million — option plans being granted. "The governance world has created some concern about the megagrant," said one compensation specialist. See Patrick McGeehan, "A Remix in the Grants of Options and Stock," *New York Times*, April 6, 2003.
87. See the International Corporate Governance Network *ICGN Statement on Institutional Shareholder Responsibilities*, issued on February 21, 2003 and revised on May 22, 2003, which is accessible online at [www.icgn.org](http://www.icgn.org). Among the areas delineated that affect both institutional investors and their agents are general ownership responsibilities, protocols for proxy voting, accountability standards and practices, conflicts of interest provisions, and procedures for moving forward and evaluating progress.
88. Interview with Rep. J. James Marzilli, March 20, 2003.
89. Thorstein Veblen, *Absentee Ownership—Business Enterprise in Recent Times: The Case for America* (New York: B.W. Huebsch, 1923; reprint, with introduction by Marion J. Levy, Jr., New Brunswick, NJ: Transaction Publishers, 1997), 6. Veblen's concerns expressed 80 years ago remain as fresh as wet paint. "In recent times absentee ownership has come to be the main and immediate controlling interest in the life of civilized men," he wrote in 1923. "It is the paramount issue between the civilized nations, and guides the conduct of their affairs at home and abroad....At the same time and in the same degree it has, as a matter of course, become the chief concern of the constituted authorities in all the civilized nations to safeguard the security and gainfulness of absentee ownership. This state of things is now plain to be seen, and it is therefore beginning to cloud the sentiments of the underlying population at whose cost this security and gainfulness are maintained." *Absentee Ownership*, 1,4.
90. Adolph A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (New York: Macmillan, 1932; reprint, with new introduction by Murray L. Weidenbaum and Mark Jensen, New Brunswick, NJ: Transaction Publishers, 1991).
91. Source: Standard & Poor's Money Market Directories, Inc., 2003. Standard & Poor's MMD products include a directory of information on pension funds and their advisors, costing \$1,050; one listing tax-exempt organizations, for \$450; a directory of international pension funds and their advisors for \$475; and so on. A free summary of institutional investors, organized by plan types and asset value, can be viewed by visiting the Standard & Poor's Money Market Directories website at [www.mmdaccess.com](http://www.mmdaccess.com).
92. Widely viewed in the corporate governance community as one of the most authoritative sources of information on institutional investment and control patterns, Carolyn Brancato's reports are the cornerstone of the Conference Board's Global Corporate Governance Research Center; produced twice a year, on the topics of "Financial Assets, Equity Holdings & Investment Strategies in the U.S." and "Equity Ownership and Investment Strategies of U.S. and International Institutional Investors." Annual subscriptions are \$650; further information can be obtained by visiting The Conference Board's website at [www.conference-board.org](http://www.conference-board.org).
93. See Brad Wolverton, "No More Wiggle Room — Big U.S. Foundations See Drop in Assets for Third Straight Year," *The Chronicle of Philanthropy*, March 6, 2003. Among 131 grantmakers reporting data for fiscal year 2001 and 2002, foundation assets fell by a median of 9 percent last year, the *Chronicle* reported.
94. See "Community Foundations' Assets, Gifts, and Grants in 2002," *The Chronicle of Philanthropy*, September 19, 2002. These statistics are based on an annual survey conducted by the Columbus Foundation in Ohio and the Washington-based Council on Foundations, and is available online at [www.columbusfoundation.org](http://www.columbusfoundation.org).
95. The combined assets of the nation's mutual funds decreased by \$2.0 billion, or 0.03 percent, to \$6.266 trillion in March, according to the Investment Company

- Institute's official survey of the mutual fund industry. Assets of worldwide mutual funds, which include statistics from 37 countries, rose 5.2 percent in the fourth quarter of 2002 to \$11.2 trillion. Source: Investment Company Institute, 2003. Regular updates on the mutual fund industry, which includes survey research on approximately 8,300 U.S.-based mutual funds, can be obtained from the ICI by registering at their website, [www.ici.org](http://www.ici.org).
96. Source: Carolyn Kay Brancato, *Institutional Investment Report — Financial Assets and Equity Holdings*, Vol. 4, #1 (New York: The Conference Board, November 2000).
  97. An impressive guide to socially responsible mutual funds was recently published by SocialFunds.com. *Investing in Socially Responsible Mutual Funds* contains information and a fact sheet on this growing specialty, and can be obtained by registering at the SocialFunds.com website at [www.socialfunds.com](http://www.socialfunds.com).
  98. Even though social funds address the normative dimension of business behavior, most of them fail to report on the values, rules, and procedures for voting their proxy resolutions. Domini Social Investments was the first mutual fund to do so; even here, however, decisions regarding proxy policy, campaigns, and areas of concentration remain in-house, relying heavily on staff recommendations made by KLD Research & Analytics, Inc., a corporate social research advisor to DSI. To my knowledge, none of the social funds provide a "town meeting" like forum for discussion of prevailing sentiment regarding investment policy and practice, or empirical evidence on how public policy concerns such as global warming affect — and are affected — by their decisions. Nor do they maintain ongoing relationships with reputable research and development, academic, or public policy institutes to aid their deliberations on the social consequences of various positions.
  99. The use of the term "islands of governance" is borrowed from Kennedy School Dean Joe Nye's use of the term, referring to the plethora of non-state institutions that pepper the global landscape. Nye's contention is that global governance (not global government) is constituted by a variety of transnational actors, including subunits of governments, corporations, and nongovernmental organizations. Referring to the emergence of an International Criminal Court to address human rights issues, Nye describes the increasing role of international institutions devoted to special interests. "At the global level, what we find is not world government but the existence of regimes of norms, rules, and institutions that govern a surprisingly large number of issues in world politics. The islands of governance are more densely concentrated among developed states, but they often have global extension." The challenge, he maintains, is to form coalitions and trisectoral partnerships, where "areas of inter-governmental coordination exist in a competitive and cooperative relationship with private and third sector actors that provide some governance for several issues in global politics....Transnational communications, coupled with political democracy, promote the development of global norms as a backdrop against which the islands of governance stand out." See Robert O. Keohane and Joseph S. Nye, Jr., "Introduction," in *Governance in a Globalizing World*, Visions of Governance for the 21st Century, edited by Joseph S. Nye, Jr. and John D. Donahue (Washington, D.C.: Brookings Institution Press, 2000), 20, 24.
  100. James Madison, n.d., in Merrill Jensen et al., eds., *The Documentary History of the Ratification of the Constitution* (State Historical Society of Wisconsin, 1976— ), vol. 10, 417, appearing in Garry Wills, *James Madison*, ed. Arthur M. Schlesinger, Jr. (New York: Henry Holt and Company, 2002), 36.
  101. Conversation with Martin S. Kaplan, August 6, 2002.
  102. Interview with Robert A. Glassman, December 3, 2002. The Boston Foundation's so-called "Harmony Statement" was initially conceived by former TBF board members Paul N. Ylvisaker and Dwight Allison, who served as board chair, in the mid-1980s, when concerns about investment policy and South Africa were at their peak. In 1985, Allison, who at that time was a director of The Boston Company and CEO of Boston Safe Deposit & Trust, maneuvered the Foundation into adopting a set of South Africa-related restrictions on its investment policy. Ten years later, David Rockefeller, Jr. picked up the gauntlet, and the board's discussion of civic investment criteria led to the passage of the Harmony Statement in 1995. Updated in 1999, the Harmony Statement acknowledges "the dual responsibility on the



- Foundation to invest its assets in companies which will serve as a vital source of capital growth and income generation, while at the same time not undermining its efforts as a grantmaker, advisor, and contributing member of the Boston community." See *The Boston Foundation Statement of Investment Objectives, Goals, and Policy Guidelines, 1999*. The Boston Foundation's current *Policy on Socially Responsible Investing and Proxy Voting Guidelines – 2003* can be obtained by visiting its website at [www.tbf.org](http://www.tbf.org).
103. Interview with James A. Pitts, April 16, 2002.
  104. In order to maintain their tax-exempt status, under current law foundations must spend at least 5 percent of their assets each year, an amount that covers both charitable grants and certain administrative expenses such as salaries, rent, travel, and so forth. A controversial bill to change the existing payout law is pending in the House of Representatives; the bill would require foundations to distribute the entire 5 percent as grants, rather than be used to underwrite administrative costs. Another controversial proposal affecting foundation payout schedules recently was made by former senator Bill Bradley and his McKinsey & Company colleagues, who suggested in a recent *Harvard Business Review* article that funders adopt a 7 percent scheme while exploring other forms of socially responsible investing to get more "social bang for each invested buck." Although the Bradley piece addresses five ways in which foundation endowments can become more productive, it fails to address the leverage available as a result of responsible equity ownership. See Bill Bradley, Paul Jansen, and Les Silverman, "The Nonprofit Sector's \$100 Billion Opportunity," *Harvard Business Review*, May 2003.
  105. Glassman interview.
  106. Remarks of Robert A. Glassman made to "Foundation Meeting on Proxy Voting Considerations," hosted by the Nathan Cummings Foundation in New York City, January 24, 2003. These recommendations emerged as a result of an email exchange between the author and Glassman prior to the event.
  107. See Caroline Williams, "Who's Minding the Store?" *Foundation News & Commentary*, March / April 2003, Vol. 44, No. 2, which can be accessed at [www.foundationnews.org](http://www.foundationnews.org). The Nathan Cummings Foundation, named after the founder of the Sara Lee Corporation, is rooted in the Jewish tradition and committed to democratic values and social justice, including fairness, diversity, and community. According to its family legacy statement, "The children, grandchildren, and great grandchildren of Nathan Cummings inherited his spirit of sharing and community, and they continue his philanthropic work by contributing their time and energy to the foundation that bears the family name." The Nathan Cummings Foundation is well known for its integrity and innovation, and under the leadership of Lance E. Lindblom, has taken a measured yet constructive stance with respect to shareholder activism. Further information on the Nathan Cummings Foundation can be obtained at [www.nathancummings.org](http://www.nathancummings.org).
  108. Interview with Caroline Williams, February 6, 2003.
  109. See Lance Lindblom, "We're Owners, Not Traders," *Foundation News & Commentary*, September / October 2002, Vol. 43, No. 5.
  110. Steve Viederman's work as co-founder and co-director of the Initiative for Fiduciary Responsibility is in partnership with The Global Academy, an electronic university-without-walls that concentrates on issues of critical importance. His essay, "New Directions in Fiduciary Responsibility," puts the financial stewardship role in context, and presents a set of new and redefined obligations that result. Adopting a more holistic approach, the Initiative for Fiduciary Responsibility challenges the current use of "triple bottom line" thinking, which refers to financial, social, and environmental outcomes, by asserting "that the integration of prudent financial management practices with principles of environmental stewardship, concern for community, labor and human rights, and corporate accountability to shareholders and stakeholders – which until recently have not been considered relevant to the financial decision-making process constitute in fact a single bottom line." Its purpose, therefore, is to "facilitate the evolution and implementation of this expanded concept of fiduciary responsibility in the interest of both institutional investors and society as a whole." Further information on Viederman's essay and the Initiative for Fiduciary Responsibility can be obtained by visiting The Global Academy's website at [www.theglobalacademy.org](http://www.theglobalacademy.org).