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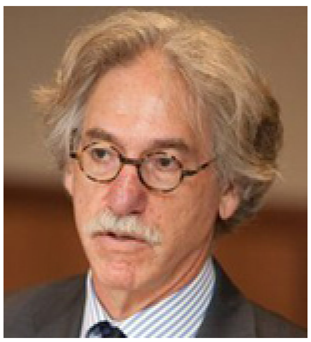

Mobilizing Ownership: An Agenda for Corporate Renewal

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With Barack Obama trying to bell rival Mitt Romney as the embodiment of ruthless capitalism, and Romney countering that the president suppresses enterprise, the nature of the corporation is center stage as never before in a modern US election campaign. Yet both candidates may be missing out on a promising agenda to stimulate growth and responsibility. Their competing visions of the corporation address innovation, management and board oversight. But when it comes to public companies, there is a vital but chronically under-explored question. Institutional investors now control up to 80% of equity in major markets.[1] They have vast, mostly unseen, influence over corporate America. But are they fit for purpose as owners?[2] If too many fail effectively to 'watch the store', the risks of repeat systemic crises, fraud, CEO pay for failure and anemic value creation across the country will remain elevated. On the other hand, if more investors oversee corporate boards in alignment with the interests of long-term savers, we may find the key to a functional, robust and sustainable—and even socially responsive—market. Reimagining the corporation, in other words, may require us to reimagine ownership.

The question is urgent. Forensic analyses of the financial crisis detected the fingerprints of institutional investors all over the behavior of banks who undertook excessive risks to pop stock prices. "Short-termism is a disease that infects American business and distorts management and boardroom judgment,"

[1] The figure is 73% in the US. See Ronald Gilson and Jeffrey Gordon, "Capital Markets, Efficient Risk Bearing and Corporate Governance: The Agency Costs of Agency Capitalism" (2012), accessible at https://coursewebs.law.columbia.edu/coursewebs/cw_12S_L9519_001.nsf/0f66a77852c3921f852571c100169cb9/C52A6786C57B3B52852579830053479F/$FILE/GilGor+Oxford+Prelim+Draft.Conf+Final.011012.pdf?OpenElement.

[2] Some scholars assert that institutional investors are not legal owners of public companies even though they hold stock (Lynn A. Stout, *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations and the Public*, Berrett-Koehler Publishers, 2012). Others counter that market participants, and many courts, commonly treat such institutions effectively as owners. This paper uses the term owner in concert with market convention.

asserted Martin Lipton, Theodore Mirvis and Jay Lorsch in a 2009 paper. "But it does not originate in the boardroom. [It] is bred in the trading rooms of the hedge funds and professional institutional investment managers…"[3] The February 2012 interim report of Britain's Kay Review noted similar phenomena: shareholders encourage "companies to engage in financial engineering, to run their businesses 'to make the numbers,' or otherwise to emphasise short term financial goals at the expense of the development of the business capabilities."[4]

Data is mixed about just how short share holding periods have really become. Some alarmist numbers point to high-frequency trading that sees investor "ownership" of a company existing for little more than nanoseconds. Other researchers argue that underlying timeframes may still be measured in years.[5] Either way, there is little dispute that many corporations are prone to cut research and development and shrink jobs, if that's what it takes to keep quarter-fixated investor analysts happy and stock prices buoyant.[6] Boards even penalize CEOs if they do otherwise; one study found that executives who failed to meet two quarterly analyst consensus forecasts in a year get 24% less in stock and 14% less in cash bonuses than those who match analysts' short-term expectations.[7] The pop world maxim 'you are what you eat' may find an echo for companies: you are what your owners allow you to be.

The question of whether institutional investors are prudent stewards is bound to become even more pressing. Just why may be appreciated from the cockpit of the Duke of Cambridge's Royal Air Force helicopter. The UK military's storied air-sea rescue unit—despite being staffed with the heir to the British throne—has now been slated for privatization to cut costs. In fact, the debt crisis facing Europe and the United States is forcing governments at all levels to shrink budgets by hiving off programs, even those once considered sacrosanct, into the for-profit sector. Air-sea rescue is only the beginning. Over-stretched governments may have to send certain health care, transportation, education, libraries, prisons and a tide of other treasured services into the eager subdivisions of corporations.

This great offloading is occurring at an awkward moment. The Occupy phenomenon gave voice around the world to public anger against big corporations and financial institutions. Dismay in the US focused on executive pay and corporate political influence—particularly at bailed-out enterprises. As

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[3] Andrew Keay, "The Global Financial Crisis: Risk, Shareholder Pressure and Short-termism in Financial Institutions," 2011. Accessible at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1839305.

[4] "The Kay Review of UK Equity Markets and Long Term Decision Making—Interim Report," February 2011. Accessible at http://www.bis.gov.uk/assets/biscore/business-law/docs/k/12-631-kay-review-of-equity-markets-interim-report.

[5] For instance, see Martijn Cremers and Antti Ptajisto, "How Active is Your Fund Manager? A New Measure that Predicts Performance," (2009). Accessible at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=891719.

[6] John Graham, Campbell Harvey and Shiva Rajgopal, "The Economic Implications of Corporate Financial Reporting," (2005), accessible at http://faculty.fuqua.duke.edu/~charvey/Research/Working_Papers/W73_The_economic_implications.pdf.

[7] Rick Mergenthaler, Shiva Rajgopal and Suraj Srinivasan, "CEO and CFO Career Penalties to Missing Quarterly Analysts Forecasts," (September 2008), accessible at http://hbswk.hbs.edu/item/6019.html.

more public services shift into private hands, such movements are likely to expand attention to a wider range of companies, and how they behave as citizens. To be sure, the most desperate spinoffs and angry public reactions may be in debt-crippled Greece, Spain, Italy, France, Ireland and Britain. But states such as California face equally radical cuts as they work to balance budgets.

The collision of public sector downsizing and citizen distrust of private enterprise makes inevitable further scrutiny of corporations—not just of their boardrooms, but of the intimately-connected issue of who owns such companies and what these owners ask corporate executives to do. The way this debate plays out will shape thinking about the purpose and possibilities of companies for years to come.

One Hand Clapping

That the corporation is in such disrepute is in many ways ironic and unexpected. CEO credibility, for instance, already low, tumbled by a record amount in 2011, according to the Edelman Trust Barometer.[8] How can that be? For decades markets around the world have forced accountability on companies by a radical, if slow-motion, dismantling of battlements that once allowed entrenched insiders to run enterprises as they wished in relative secrecy. In 1962 one director in the UK could describe the job of board oversight in this way: "No effort of any kind is called for. You go to a meeting once a month in a car supplied by the company. You look both grave and sage and, on two occasions, say 'I agree,' say 'I don't think so' once and, if all goes well, you get £5,500 a year."[9]

The modern boardroom is planets away from that *Mad Men* era. A parade of unprecedented changes in the US alone has made corporations more open. Board elections are now meaningful at 79% of S&P 500 companies; directors at those firms are subject to ouster if they lose investor confidence.[10] Shareholders as of 2011 have an annual (non-binding) vote on executive pay, giving them tools to curb the worst excesses—like Shaw Engineering's memorable 2008 contract to pay its CEO $17 million for not competing with the company after he dies.[11] The imperial chief executive serving as his own boss is becoming less common: in 2011 an unheard-of 46% of big US public companies featured a separate chair of the board.[12] Takeover defenses that protected even the worst CEOs from ejection are disappearing; companies with poison pills now number less than 900,

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[8] 2012 Edelman Trust Barometer, accessible at http://trust.edelman.com/.
[9] Stephen Davis, Jon Lukomnik and David Pitt-Watson, *The New Capitalists: How Citizen Investors are Reshaping the Corporate Agenda* (Harvard Business School Press, 2006), p. 104.
[10] *Board Practices 2012*, ISS. See http://blog.issgovernance.com/gov/2012/03/iss-releases-2012-board-practices-study.html.
[11] Mark Maremont, "Companies Promise CEOs Lavish Posthumous Paydays," *The Wall Street Journal*, June 10, 2008, http://online.wsj.com/article/SB121305922859459465.html.
[12] Ibid and *Spencer Stuart Board Index 2011*, accessible at http://www.spencerstuart.com/research/articles/1538/.

compared to 2,200 a decade ago.[13] Poor-performing CEOs are getting exit papers when trouble starts instead of when it is too late.[14] And, of course, rules and regulations stemming from the Sarbanes-Oxley and Dodd-Frank Acts have installed fresh protections against fraud and cavalier approaches to risk.

What's not to like? Taken together, these reforms amount to a root-and-branch overhaul of corporate governance. Indeed, since Enron, lawmakers in the US and Europe have bet that if boards can be made more responsive to investors, these owners would act to police failing, rogue or rapacious corporations. "If [investors] are unhappy, we don't want them just to sell up and move on, we want them to throw their weight around so that the company improves," declared UK Deputy Prime Minister Nick Clegg in a January 16 2012 speech.[15] Sure enough, measures in the US Dodd-Frank Act, Europe's Green Paper on corporate governance and legislation in Britain took still further steps empowering shareowners to intervene in executive pay, board composition and corporate citizenship.

Unfortunately, though, these approaches may turn out to be something akin to the sound of one hand clapping. For as much effort as policymakers have spent modernizing corporate structures, they have devoted comparatively little attention to the institutional investors they count on to oversee the market. In fact, a host of archaic barriers prevent all but a handful of funds from meeting the high expectations placed on them as owners of public corporations. Some observers even contend that the consequence of decades of governance reinvention must now be seen as deeply harmful. Yes, these critics concede, reform succeeded in making corporate boards responsive—but to funds that are habitual short term traders, not long-term capital stewards. If that is true, policy has unwittingly put CEOs and company directors under more pressure than ever to pursue speedy profit over long-term value and social responsibility. "Corporations continue to place a strong emphasis on quarterly returns, because investors do," notes governance thought leader Ira M. Millstein.[16] As one key report concluded, "The obsession with short-term results by investors, asset management firms, and corporate managers collectively leads to the unintended consequences of destroying long-term value, decreasing market efficiency, reducing investment returns, and impeding efforts to strengthen corporate governance."[17] No wonder, then, that the corporation—even reformed, maybe *especially* reformed—continues to fail tests of public trust.

[13] *Poison Pills in 2011*, The Conference Board, March 2011, accessible at http://www.conference-board.org/publications/publicationdetail.cfm?publicationid=1913.
[14] *CEO Succession Practices 2012*, The Conference Board, April 2012, accessible at http://www.conference-board.org/publications/publicationdetail.cfm?publicationid=2168.
[15] "Deputy Prime Minister's speech at Mansion House," Office of the Deputy Prime Minister of the United Kingdom, January 16, 2012. Accessible at http://www.dpm.cabinetoffice.gov.uk/news/deputy-prime-minister-s-speech-mansion-house.
[16] Ira M. Millstein speech at PLI Ninth Annual Directors' Institute on Corporate Governance, September 7, 2011.
[17] "*Breaking the Short-Term Cycle,*" the CFA Centre for financial Market Integrity and Business Roundtable Institute for Corporate Ethics (July 2006), accessible at www.cfapubs.org/toc/ccb/2006/2006/1.

If most institutional investors are indeed wanting as prudent stewards of public corporations, then it follows that Dodd-Frank and other market adjustments adopted in the wake of scandal and crisis are fatally flawed for having empowered shareholders. Some who make that charge conclude that remediation must begin with a rollback of shareowner powers. Independent, skilled corporate boards unfettered by investor activism are the best champions of invigorated business, they contend.[18] The 2012 JOBS Act made a start at this by waiving Sarbanes-Oxley and Dodd-Frank investor protections for certain classes of US companies.

This paper explores an alternate path: a policy agenda, mirroring corporate governance reforms, designed to strengthen the capacity of institutional investors to act as long term owners. Making both hands clap, in other words. To be clear, institutional shareowners should never be in the business of running public corporations. That job is rightly for boards to supervise and managers to execute.[19] The fate of enterprises rests in their hands. But reforms to shareholding institutions, if successful, could install more prudent oversight of public companies and open space for more expansive concepts of corporate purpose. To identify those options requires, first, an inquiry into impediments to responsible ownership.

Roman Rule

Historians have traced the peculiar gauge of US railroad tracks (4 feet 8.5 inches) back more than two thousand years to the distance Roman war chariots required to accommodate the width of two horses' backsides. While perhaps apocryphal, the story neatly captures the way hidden legacies can sway modern behavior. In a similar way, rules and practices inherited from an obsolete capital market haunt the investment world's ability to assume stewardship duties.

Decades ago, dominant investors in US equity were wealthy families.[20] Boards, as noted, were often supine. Pension plans offered by companies and public agencies were almost all "defined benefit", promising members a fixed amount of income upon retirement. Investments were largely in debt instruments or blue chip domestic stock, yielding unexciting but steady returns. Desultory investing made actuarial sense: current workers generating savings far outnumbered pensioners needing cash, especially as average life spans kept

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[18] An example of this approach may be found in Martin Lipton, Theodore Mirvis and Jay Lorsch, "The Proposed 'Shareholder Bill of Rights Act of 2009,'" accessible at http://blogs.law.harvard.edu/corpgov/2009/05/12/the-proposed-%e2%80%9cshareholder-bill-of-rights-act-of-2009%e2%80%9d/.

[19] The board's significance was outlined early in Winthrop Knowlton and Ira M. Millstein, "Can the Board of Directors Help the American Corporation Earn the Immortality it Holds So Dear?", in *The US Business Corporation: An Institution in Transition* (Ballinger, 1988). See also Paul MacAvoy and Ira M. Millstein, *The Recurrent Crisis in Corporate Governance* (Stanford University Press, 2004).

[20] In 1950 institutions owned just 6.1% of US equities. Gilson and Gordon (2012).

retirement relatively short. Few funds paid attention to share voting, which was considered not a guardian of value but rather a quaint formality allowing portfolio companies to enact routine matters such as ratifying director appointments. Those few engaged funds that did pay attention, having meager rights under US law, were forced to raise alarms about corporate conduct through the surrogate process of filing shareholder resolutions.

Today, investors owning most of US corporate equity form a vast panoply of funds representing, in the main, assets of millions of working and middle class citizens at home and abroad who are saving for retirement and health care expenses.[21] Defined benefit schemes are dying out, replaced by "defined contribution" plans that shift risk to individuals typically invested in mutual funds. Once at the margins of the US investing world, mutual funds are now behemoths critical to savings. Complexity rules; one study tracked no fewer than 16 different intermediaries escorting—each for a price—the citizen-shareowner's money to a company's stock.[22] Portfolios may contain everything from hedge funds to plain-vanilla equity, covering multiple markets and asset classes spread across the globe. Demographics place a new urgency on high returns: current workers are fewer in number while the universe of retirees is ballooning and people live longer than ever. Share voting is now often required and disclosed, as regulators consider the ballot a means to protect the interests of beneficiaries. And the powers US investors now enjoy to sway board composition and compensation are unprecedented.

For all that sweeping change, the market is forced to live with practices, and a culture, shaped to a now-disappeared era. Problems may be found in four major baskets.

Misgovernance

Take governance—that is, how transparent an institutional investor is, and how accountable to and aligned it is with the ultimate beneficiaries it serves. Mounting evidence (in an admittedly little-studied field) suggests that a fund's governance is perhaps the single most critical factor in predicting its performance *both* as a prudent owner of equity *and* as a savings vehicle. Why? An institution's governing body oversees strategic judgments such as time horizons, conflicts of interest, whether to compensate fund managers for long or short term results, and how a fund—or its agent—acts as an owner of corporate equity to enable or inhibit bad behavior by public company boards. High quality governance appears to be a prerequisite for meaningful long term strategy,

[21] In 2009 the US had more than 700,000 pension funds, 8,600 mutual funds, 7,900 insurance companies, 6,800 hedge funds and 2,200 funds of funds. Ben Heineman, Jr. and Stephen Davis, "Are Institutional Investors Part of the Problem or Part of the Solution?" (2011), Committee for Economic Development and Yale School of Management-Millstein Center for Corporate Governance and Performance. Accessible at http://millstein.som.yale.edu/sites/millstein.som.yale.edu/files/80235_CED_WEB.pdf.
[22] Private study prepared for HM Treasury, November 2011.

according to a 2012 World Economic Forum study authored by Josh Lerner.[23] Other research finds that well-governed funds outperform bottom-ranked counterparts by as much as 2.4% per year.[24] Over a lifetime, leakage in value for a saver locked into a laggard plan can be substantial. "If a typical British and a typical Dutch person save exactly the same amount for their retirement, the Dutch person will end up with a 50% larger pension," found a Royal Society of Arts report, citing collective, low cost, high governance features of Dutch plans.[25] Evidence—so far only anecdotal—suggests that better governed funds will tend to play a more active role as owners of corporate equity by voting critically on boards and filing shareowner resolutions.

Yet U.S. law in recent years has largely failed to address the governance of institutional investors. Corporate plans are still typically overseen by a single fiduciary who is a company executive; there is no multi-stakeholder trustee board such as exists at cross-industry ("Taft-Hartley") funds or in markets such as Australia. Indeed, the last major legislative effort to provide for accountability in defined contribution plans failed in a Senate committee as long as a decade ago. The "Protecting America's Pensions Act of 2002", introduced by Senator Edward Kennedy (D-MA), would have established a trustee board with an equal number of employer and employee representatives for 401(k) plans with more than 100 participants.

Most mutual fund board directors are only rarely subject to election even though they are meant to serve as agents of citizens who invest with the fund company. For their part, hedge funds need reveal only token details about themselves. US public employee funds are subject to state laws, which vary greatly in what disclosure they require and how boards are composed. Where trustees do exist, skill requirements in statute are minimal, and many boards are seen as captive to professional advisors or to constituents who appointed them. A 2001 probe of pension governance competency in Britain found that "many trustees are not especially expert in investment". The US faces similar challenges. But where the UK adopted a new Pensions Act with requirements for trustee expertise, no comparable undertaking has occurred in the US.[26]

In sum, even though the behavior of public companies and the security of retirement plans both increasingly depend on the behavior of investment agents, governance at the top of these institutions can be deeply archaic, and not just in the US. Does that matter?

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[23] Josh Lerner, "Measurement, Governance and Long-term Investing," World Economic Forum (2012), accessible at http://www3.weforum.org/docs/WEF_IV_MeasurementGovernanceLongtermInvesting_Report_2012.pdf.

[24] K. Ambachtsheer, R. Capelle and H. Lum, "The Pension Governance Deficit: Still With Us" Rotman International Journal of Pension Management, Vol. 1, No. 1 (2008). accessible at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1280907.

[25] David Pitt-Watson, *Tomorrow's Investor: Building the consensus for a People's Pension in Britain*, Royal Society for the Arts (2010), accessible at http://www.thersa.org/__data/assets/pdf_file/0009/366948/RSA-TI-report-Pensions.pdf.

[26] Lerner (2012), p. 33.

Consequences for savers, certainly, are important. Several influential studies have found that mutual funds, apparently unchecked by boards, place "important business interests…in asset gathering ahead of their fiduciary duties" to grassroots savers.[27] Funds may also make investment allocation decisions designed to help gain and retain 401(k) corporate clients even at a substantial financial penalty to savers.[28] Vanguard founder John C. Bogle has spotlighted the titanic costs to investors when mutual funds with permissive boards tolerate stock churning with attendant fees and sales loads.[29] A 2009 Aspen Institute report agreed, finding that "funds engage in behavior that is inconsistent with their investors' goals."[30] We have already noted data suggesting the annual leakage of value when beneficiaries entrust their money to market agents that are out of synch with savers' interests. Though retirement security is ever more dependent on the investment industry, that sector is "purpose-built for ambiguity and lack of accountability," observed Australia's 2010 Cooper Review into fund governance, "a condition that favors the interests of everyone but the [beneficiaries]."[31]

Equally, consequences for public corporations may be harmful when institutions that own them feature substandard governance impeding prudent ownership. Investor conflicts of interest, for instance, seem to disarm engaged monitoring even when a portfolio company's management is going wrong—say, with a dodgy takeover. One notorious example, exposed through rare leaks and court challenges, occurred in 2002. Hewlett-Packard threatened to drop business with Deutsche Bank's investment banking arm unless the bank's asset management unit switched 17 million proxy votes to back HP's controversial merger with Compaq Computer. Deutsche complied.[32] The takeover has since been widely viewed as a failure. But conflicts of interest short-circuited at least one investor's initial message at the time to halt.

At the market-wide level, unchecked conflicts may be behind the oft-cited statistic that not one US corporate fund has ever filed a shareholder resolution expressing dissent with another corporate board. Conflicts work in other ways, too. Within a single investment house, asset managers eager to retain access to corporate executives may override the judgment of governance experts who

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[27] Jennifer Taub, "Able But Not Willing: The Failure of Mutual Fund Advisors to Advocate for Shareholders' Rights," *Journal of Corporation Law* Vol. 34 No. 3, 2009.

[28] Lauren Cohen and Breno Schmidt, "Attracting Flows by Attracting Big Clients: Conflicts of Interest and Mutual Fund Portfolio Choice" (2007), accessible at http://www.chicagobooth.edu/research/workshops/finance/docs/cohen_attractingflows.pdf.

[29] Over 25 years ending in 2005 mutual funds reaped USD500 billion in fees while delivering returns less than one third of the figure investors would have made had they put savings into an index. John C. Bogle, *Enough* (John Wiley & Sons, 2009), p. 82.

[30] The Aspen Institute Business & Society Program, *Overcoming Short-Termism: A Call for a More Responsible Approach to Investment and Business Management* (September 9, 2009). Accessible at www.aspeninstitute.org/sites/default/files/content/docs/bsp/overcome_short_state0909.pdf.

[31] See http://www.supersystemreview.gov.au/.

[32] "SEC Brings Settled Enforcement Action Against Deutsche Bank Investment Advisory Unit in Connection with Its Voting of Client Proxies for Merger Transaction; Imposes $750,000 Penalty," *Securities and Exchange Commission*, (August 19, 2003), accessible at http://www.sec.gov/news/press/2003-100.htm.

may, for instance, want to vote against overpaying a CEO responsible for poor performance. Or an institution shorting a stock may have an economic incentive to keep a corporate board ineffectual.[33] In sum, an institutional investor's appetite to pursue its own commercial interests can trump its duty to grassroots investors, neutering its capacity to police portfolio company boards. The signals corporate directors then receive may enable poor, short-term or conflicted decision making.

Yesterday's Fiduciary?

Fund governance isn't the only weak link in the discipline of ownership. Today's fiduciary standards, the legal guardrails that determine what investors can and cannot do with respect to portfolio companies, are the product of a time when corporate value could best be gauged by calculating a company's stock of physical assets, bricks and mortar. In that earlier context, it was arguably rational that fiduciary rules should carve a narrow channel for investor action. Shareholders, as owners of public equity, could press companies solely on matters defined as strictly financial. The SEC enforced this as the gatekeeper of what shareowner resolutions it would approve or block. In the UK, the Megarry judgment in *Cowan v. Scargill* (1985) kept investor action to within similar limits.

Today's calculus is far more complex; corporate value rests as much on intangibles such as "human capital," that is, how employees are recruited, trained, motivated and retained; on reputation and brand identity; and on capacity to create applied knowledge. Consumer trust is understood as central to value. So is management of environmental risk—just ask BP or Tokyo Electric Power. And in an age when social media empowers any whistleblower, information leaker or disgruntled neighbor to send complaints viral, the quality of risk oversight is critical to corporate welfare. It is no surprise that consultants such as McKinsey now have whole businesses devoted to helping companies nurture intangible assets, or that accounting firms, who best know the limits of traditional audits, devote substantial research to fresh measurement of value. The international initiative to develop "integrated" reporting provides a window on just how profoundly lacking are conventional techniques of assessing corporate performance.[34]

For all the new insight into what makes companies valuable, fiduciary duty is largely stuck in a bygone era. Lawyers counsel, for instance, that funds act most prudently if they follow investment behavior commonly used by other institutional investors. That 'prudent man' rule made sense in the 1960s, when

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[33] Simon Wong, "Barriers to Effective Investor Engagement," *Financial Times* (January 15, 2012); and "Why Stewardship is Proving Elusive for Institutional Investors," *Butterworths Journal of International Banking and Financial Law* (July/August 2010). See also Andrew Mark Clearfield, "With Friends Like These, Who Needs Enemies? The Structure of the Investment Industry and Its Reluctance to Exercise Governance Oversight," *Corporate Governance: An International Review* Vol. 13 No. 2 (March 2005), accessible at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=684302.

[34] See www.theiirc.org.

the investment industry was immature as far as retail shareholders were concerned. Today such advice often overwhelms other duties and serves as a "lemming standard" which drives the market's "unrelenting focus on short-term results," observe analysts Keith Johnson and Frank Jan de Graaf.[35] The herd approach breaches the fiduciary obligation to impartially balance the divergent financial needs of all beneficiaries, whether they are first-year employees, middle aged workers or elderly retirees. After all, an obsession with short-term investing may run counter to the institution's simultaneous responsibility to generate patient returns over decades. But this 'duty of impartiality' is today largely ignored because it drew little attention in the years when funds were first created and workforce demographics were wholly different.

Copycat investment takes a further toll. It discourages a focus on extra-financial risks at portfolio companies because such factors fall outside of what shareholders favor under conventional interpretations of their fiduciary duty. At least two studies—the Freshfields Report and one by FairPensions—make cases that an updated understanding of fiduciary duty legitimizes investor attention to extra-financial risks precisely because such risks relate directly to long-term value creation.[36] So far, though, these studies have not widely transformed practice. As a result, efforts to shift corporate purpose toward sustainable growth still run into resistance by mainstream investors who, while often acting as the agent of long-term beneficiaries, insist on capital allocated for maximum quarterly results. That's a message corporate boards are hearing on a regular basis.

Rusty Plumbing

Misalignments in fund governance and fiduciary duty are joined by a third legacy that hinders capacity for prudent ownership: outdated plumbing behind the framework of shareowner democracy.

Start with proxy voting, the virtual oxygen of ownership. Investors rely on this system more than any other to make public corporations accountable. Ballot outcomes each year determine the composition of boards, the fate of mergers, compensation of key executives, and strategic decisions that affect the firm and its stakeholders. But today's proxy machinery was erected more than 70 years ago when voting, barely exercised, was considered little more than a routine annoyance. In 1988 the US Department of Labor administered a shock through its landmark 'Avon letter': it required regulated pension plans to

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[35] Keith Johnson and Frank Jan de Graaf, "Modernizing Pension Fund Legal Standards for the 21st Century," *Rotman International Journal of Pension Management* Vol. 2 No. 1 (Spring 2009). See also Steve Lydenberg, "Reason, Rationality and Fiduciary Duty", IRRC Institute (2012), accessible at http://www.irrcinstitute.org/pdf/FINAL-Lydenberg-Reason-Rationality-2012-Winner.pdf.

[36] "A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment (The Freshfields Report)", UNEP Finance Initiative (2005), accessible at www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf; "Protecting Our Best Interests: Rediscovering Fiduciary Obligation," FairPensions (March 2011), accessible at www.fairpensions.org.uk/sites/default/files/uploaded_files/fidduty/FPProtectingOurBestInterests.pdf.

consider the vote an asset to be exercised at all portfolio companies.[37] The new flood of mandated ballots had to navigate a creaky, Rube Goldberg-like network of intermediaries—custodians, sub-custodians, brokers, tabulators, registrars—to reach a company annual meeting.[38] Broadridge, the firm with a near-monopoly on vote transmission in the US, has made progress in streamlining the system despite the fact that each middleman has a stake in the status quo. But proxy plumbing remains vulnerable to a 'Florida 2000'-style breakdown triggered by any number of potential errors, as the SEC found in a 2010 probe.[39]

It's not just the machinery of voting that has been rusty. Two measures served to undermine the import of board elections. New York Stock Exchange (NYSE) listing rule 452, in force for more than half a century, explicitly labeled director votes "routine," thereby allowing brokers to vote—always down the line with management—on behalf of their clients. The Council of Institutional Investors branded the practice "legalized ballot stuffing," and by some estimates so-called "broker non-votes" accounted for as much as 20% of director election ballots at a typical annual meeting.

Second, all but a handful of US public corporations ran director elections under a "plurality" standard, barring investors from being able to vote "no" on candidates for the board. Under the practice, so long as a single share was cast as "yes," directors would be installed even if every other ballot was voted "withhold," the only other option. Institutional investors exhibited a rational apathy about participating in the election process.

Broker voting was abolished for director elections, first by the NYSE after lengthy delays, and then in 2011 by the Dodd-Frank Act. Rule 452 still survives to affect certain other balloting. Plurality voting, for its part, has yielded ground under shareholder pressure to a diluted form of majority rule. Under most provisions, a corporate director must resign if he or she fails to gain a majority 'yes' vote; but the board has authority to seat the candidate regardless. In 2011 some 40 nominees who "lost" elections were nonetheless installed.[40] Still, the good news is that reforms to both measures made director elections—where outcomes are critical to determining corporate purpose and performance—far more meaningful at US corporations.

The bad news is that US institutional investors, in the main, are not configured to assume the responsibility of joining decisions about who sits on the

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[37] "Corporate Shareholder Meetings: Issues Relating to Firms that Advise Institutional Investors on Proxy Voting," US Government Accountability Office (GAO 07-765), June 2007, p. 6. Accessible at www.gao.gov/new.items/d07765.pdf.

[38] Meagan Thompson-Mann, *Voting Integrity: Practices for Investors and the Global Proxy Voting Industry*, Policy Briefing No. 3, Millstein Center for Corporate Governance and Performance, Yale School of Management (2009). Accessible at http://millstein.som.yale.edu/sites/millstein.som.yale.edu/files/Voting%20Integrity%20Policy%20Briefing%2002%2027%2009.pdf.

[39] "Concept Release on the US Proxy System," US Securities and Exchange Commission Release No. 34-62495, File No. S7-14-10, accessible at www.sec.gov/rules/concept/2010/34-62495.pdf.

[40] "Majority Voting for Directors," US Council of Institutional Investors (2011), accessible at www.cii.org/MajorityVotingForDirectors.

boards of companies they own. For one, many funds have long followed super-diversification asset allocation strategies; they hold equity in thousands of public companies around the world—too many to follow each closely without massive resources.

For another, institutions are inheritors of a bureaucratic culture derived from the long tradition of ownership without authority, which we might call "empty ownership".[41] Those US investors—mostly state-sector or labor pension funds—that considered stewardship central to value creation were diverted for lack of rights to focus on annual, non-binding shareholder resolutions on specific topics such as takeover defenses, executive pay or climate change. Corporate boards fielded these proposals as time-consuming nuisances, a sideshow compared to the prospect of shareholder influence over board composition. Most other institutional shareholders treated governance monitoring as a matter of compliance unrelated to value. They tucked monitoring staff into a silo managed by legal rather than investment executives, or outsourced share voting to agents. Even in Britain, where investors have enjoyed but systematically under-utilized broader rights, the discipline of ownership is often unintegrated into asset management. Former Guardian Media and Land Securities chair Paul Myners once famously noted how the "open-toed sandal brigade" of governance specialists is consigned to the basement of investment houses while portfolio managers upstairs make the big decisions.[42]

The dawn of consequential ownership in the United States—in particular, the authority to help compose corporate boards—puts intense strain on the antiquated infrastructure that now frames investor capacity. The plumbing—leadership, skills, strategies and resources—investors need to activate constructive stewardship is very different from what they used while waging skirmishes at the periphery of corporate influence.

What Cops?

A final legacy which inhibits the rise of an ownership culture may be found in Washington, DC. Capital market changes long ago escaped the once-rational boundaries of regulation, at least when it came to institutional investors. Consider the following two statutory pillars. In 1940 the Investment Company Act laid a framework for the then-new concept of the mutual fund, giving the SEC regulatory authority. Then, in 1974, Congress adopted the Employee Retirement Income Security Act (ERISA), naming the US Department of Labor (DOL) to oversee and safeguard most of the nation's retirement plans.

Today, of course, much of American retirement savings has shifted, for

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[41] Find a recent discussion of other limits to investor rights in Lucian Bebchuk and Robert Jackson, "The Law and Economics of Blockholder Disclosure," accessible at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1884226.
[42] Kate Burgess, "Myners Hits Out at Governance Specialists," *FT.com* (December 5, 2007), accessible at www.ft.com/intl/cms/s/0/a90c3d08-a2d4-11dc-81c4-0000779fd2ac.html#axzz1t4KimyL0.

good or ill, from the archetypical defined-benefit ERISA fund to 401(k)-style collective savings in mutual funds. But regulation designed to protect citizen nest eggs has hardly budged—with important implications for both savers and public companies.

Take the DOL. Serial probes by the Government Accountability Office have found the department—under both Republican and Democratic administrations—deficient in enforcing ERISA rules on proxy voting.[43] Despite the Reagan administration's 1988 milestone definition of the vote as an asset, Labor has long signaled that this is far down its list of priorities. Further, there is a growing backlog of advancements that have surfaced in the capital market but which appear to receive scant attention at the DOL. Fiduciary duty reform is one; do current definitions safely allow ERISA funds to consider extra-financial risks when assessing whether to invest in companies? Shouldn't fiduciary standards apply to the array of intermediaries that have grown up in recent years to advise (some say control) retirement funds?[44] Stewardship is another; codes now in place in different markets suggest that safeguarding assets hinges not just on voting but on more fulsome engagement by funds with corporate boards. And then there is fund governance; current regulations take little account of modern guidance on transparency and accountability—particularly as retirement plans migrate from defined benefit to defined contribution options, with higher fees and risks.[45]

The SEC, for its part, has no special obligation under legislation to protect retirement plans, even though long-term pension and health savings, having moved en masse into mutual funds, now lie within its jurisdiction. The Commission's charge is to protect investors as a whole. In doing so, it oversees no fewer than 35,000 entities with $48 trillion in assets.[46] Yet arguably there are distinctive features that apply to retirement plans—where members may be classed, in Delaware Chancellor Leo Strine's words, as "forced capitalists"—as compared to individuals investing freely.[47] Retirees presumably deserve assurance that agents are using every tool in prudent fashion to manage risk and add value over time. Fund members may not have the right to move cash from one money manager to another if they are unsatisfied. So the same issues of

[43] *Pension Plans: Additional Transparency and Other Actions Needed in Connection with Proxy Voting*, Government Accountability Office GAO 04-749 (August 2004), accessible at www.gao.gov/assets/250/243646.pdf.

[44] A 2008 industry survey by Create-Research found "a widespread perception in the pension world that the investment industry is perverse in one crucial sense: its food chain operates in reverse, with service providers at the top and clients at the bottom. Agents fare better than principals." See "DB & DC Plans: Strengthening Their Delivery," accessible at www.create-research.co.uk. Quoted in ICGN letter to the US Department of Labor, January 20, 2011, on Definition of Fiduciary Proposed Rule RIN 1210-AB32.

[45] Labor economist Teresa Ghilarducci is a leading critic of US 401(k) plans for retirement savings. Access her published research at http://teresaghilarducci.org/published-papers.html.

[46] Chairman Mary Schapiro, testimony on "SEC Oversight" before subcommittees of the US House Committee on Financial Services (April 25, 2012).

[47] Leo Strine, "Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance," speech delivered at the University of Iowa, March 1, 2007. Accessible at www.law.upenn.edu/academics/institutes/ile/CCPapers/040507/Strine%20Speech.pdf.

fiduciary duty, stewardship and governance apply to their agent institutions here as at the DOL. But the two agencies appear to be looking elsewhere, leaving the unique interests of the population of retirement savers falling through a gap in regulation.

How might outdated oversight of institutional investors concern the welfare of corporations? In sharp contrast with counterpart regulators in Britain, the Netherlands, Australia, South Africa and the European Commission, neither the DOL nor SEC have moved to propel constructive, long term stewardship by shareholders with long term beneficiaries. That vacuum may be one important factor permitting many institutional owners to push myopic expectations on corporate boards. With high-turnover mutual funds alone speaking for some 20 to 30% of US equity, public company directors are getting powerful, relentless signals to think short.

Two Hands Clapping: A Policy Agenda for Prudent Ownership

If corporate behavior hinges in large part on owner behavior, then it cannot be surprising that too many public companies run astray. Too many institutional shareholders are either failing to monitor portfolio company boards or are monitoring them in pursuit of quick returns. In fact, the surprise is the number and clout of funds that do follow a prudent stewardship approach to investment, despite all the formidable obstacles.[48] Research, while mixed, suggests that by doing so they enhance returns and better control risk.[49] And these patient investors tend to be constructive partners with corporate directors in support of sustainable, long term value creation. All of that is consistent with the elemental theory of free enterprise: owners do best by nurturing what they own. The policy challenge to consider, therefore, is straightforward. What tools are available to unlock prudent stewardship in the broader capital market?

First, one ground rule. To paraphrase former US defense secretary Donald Rumsfeld, we go into business with the investors we have, not the ones we might wish to have. Legions of experts have argued for a root-and-branch overhaul of the way retirement savings is managed in the US. “The 401(k) is a failed experiment,” economist Teresa Ghilarducci has concluded. “It is time to rethink it.”[50] Were that to happen, the shape of the capital market and institutional shareholders would presumably change. But this paper’s policy

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[48] For example, see the work of the Harvard Law School Shareholder Rights Project, accessible at http://srp.law.harvard.edu/.

[49] For example, see Elroy Dimson, Oğuzhan Karakaş and Xi Li, “Activism on Corporate Social Responsibility” (March 15, 2012), accessible at www.inquire-europe.org/seminars/2012/papers%20Budapest/SRI%20-%20Dimson%20Karakas%20Li%20v42.pdf. Also, see Stijn Claessens and Burcin Yurtoglu, “Corporate Governance and Development: An Update,” *Focus* No. 10, Global Corporate Governance Forum (2012), accessible at http://www.ifc.org/ifcext/cgf.nsf/AttachmentsByTitle/Focus10CG&Dev/$FILE/Focus10_CG&Development.pdf.

[50] Joe Nocera, “My Faith-Based Retirement,” *The New York Times*, April 27, 2012, accessible at www.nytimes.com/2012/04/28/opinion/nocera-my-faith-based-retirement.html?_r=1.

agenda is not that one, worthy as it may be. Steps outlined below envisage practical and achievable improvements working with the investors we have.

Disclosure

Lawmakers and regulators around the world have developed robust disclosure regimes covering the governance of corporations. A typical annual proxy statement issued by a US company must inform shareholders about executive and director pay, board composition and leadership, director conflicts, board committee structure, voting procedures and how investors may contact the company or file shareholder resolutions. Such transparency rules are recognized as motors of change; in fact, they are one of the SEC's main tools in investor protection. Regulators assume market participants will use information in making better decisions as traders and owners.

The contrast with institutional investors is striking. In general, they need do little reporting to beneficiaries on how they are run and overseen. This opacity limits individual shareholders, some of whom may already be restricted in where they direct their savings, in their ability to hold agents to account on costs, performance and stewardship. Transparency as a motor of change is disabled. One remedy, therefore, would be for authorities to apply the kind of reporting investors have long asked of corporations to retirement plans and other asset owners themselves. Institutions would issue a statement annually to their stakeholders on critical governance features. In effect, they could produce the equivalent of a nutrition label on accountability.

What should such a statement cover? *For one, it should explain what governance arrangements ensure that decisions are made in alignment with the interests of beneficiaries.* Some jurisdictions spell out precisely how this should be done. Australia, for instance, requires each retirement plan to feature a trustee board composed equally of sponsor corporations and plan members, and chaired by an independent non-executive. In the US, regulators could provide guidance on accountability principles without dictating specific structures. Alternatively, market participants could together craft a voluntary, but authoritative, national code of governance—with corporate and stewardship components—that embeds such guidance.[51] One minimum standard: beneficiaries should be given knowledge of not only who is serving as fiduciaries on their behalf, but also the fiduciaries' professional backgrounds, skill sets, potential conflicts of interest, independence—and how to contact them.

Second, retirement plans should describe how governance arrangements are subject to regular independent review to ensure that they meet best-practice accountability principles. The exercise is borrowed again from the corporate

[51] In 2011 the Yale School of Management's Millstein Center for Corporate Governance and Performance launched a multi-stakeholder research inquiry into the idea of an authoritative national governance code for the US. Nearly every other significant market has a corporate governance code of some kind.

governance world; it is common (and in some countries and sectors required) for directors to commission periodic assessments of their own performance as individuals and a group. Mutual fund boards have to produce such reports already. And self-evaluations are spreading among US public funds, prompting accountability reforms as a result. State retirement systems in California, Massachusetts, New York and Oregon are among those adopting the practice. CalPERS, in a public description of its process, found that it improved board effectiveness.[52]

Third, plans should identify feedback channels appropriate to the era of social media. It should be easy for grassroots members to offer and petition ideas and opinion on aspects of the plan's operations just as shareholders of corporations and mutual funds may offer resolutions on strategic direction. Two-way communication is essential to modern accountability.

Fourth, plans should describe what steps they take to test the investment interests of beneficiaries. As hard as it is for outsiders to believe, funds generally do not ask members what types of investments they need, the ownership profile they prefer or simply whether they trust the plan. A few institutions do, though. Perhaps the best example is the €100 billion Dutch health sector pension fund PFZW, covering two million members, and its asset manager PGGM. Starting in mid 2011 the duo began conducting a quarterly sample "Brand Tracker" survey of beneficiaries. Reports provide regular, unique data on how the fund is perceived and whether it is meeting the right needs.[53] Results are cycled into strategy; PGGM cites findings to support its profile as an advocate of long term stewardship.[54]

Fifth, an asset owner statement should explain how pay for portfolio managers working on behalf of the fund aligns with beneficiaries' interests. Lack of alignment can result in decisions serving the interests of money managers and advisors over participants. If a pension fund expresses investment beliefs that include a long-term investment horizon while advisors and portfolio managers it selects are evaluated and compensated on short-term criteria, it should explain why. Having to supply such information could better alert fiduciaries to the issue and help beneficiaries and regulators gauge a plan's quality.

Sixth, and finally, investment savings plans should disclose every year how they or agents use ownership tools to protect assets—and not only by the narrow-gauge measure of how they vote shares. Ballot records are in themselves useful; as shareholder champion Nell Minow puts it, they allow beneficiaries to "see who

[52] See CalPERS's discussion of the review and subsequent changes in the system's own governance at www.calpers.ca.gov/index.jsp?bc=/about/organization/board/governance-policies.xml.
[53] Reports provided to the author in April 2012 courtesy of PFZW and PGGM.
[54] One 2008 academic study found that Dutch beneficiaries would also accept a higher premium or lower retirement benefit if that is necessary to invest more responsibly. Derk Erbé, "Stille Kapitalisten: Een sociologisch onderzoek over de invloed en controle van deelnemers op het beleggingsbeleid van hun pensioenfonds," University of Amsterdam.

is voting to enable dysfunctional board behavior."[55] But there is a lot more in the stewardship toolbox with the potential to affect assets and influence corporate behavior. Funds can engage with portfolio companies in a variety of ways. They can enroll in the Principles for Responsible Investment.[56] They can join with funds to raise concerns at specific companies, through vehicles such as F&C, Governance for Owners or Hermes Equity Ownership Services.[57] They can collaborate with other investors on market-wide initiatives such as the Diverse Director Datasource, created by CalPERS and CalSTRS to improve US corporate boards.[58] They can integrate governance and extra-financial risks as part of portfolio management, including in due diligence research on companies before deciding to buy a stock, periodically while they own shares, and as part of decisions to hold or sell. Regulators, or a national code, could provide best-practice guidance on such disclosure. But if an asset owner uses only bare-minimum stewardship to safeguard beneficiary interests, it should have to disclose that and explain why.[59] A chief benefit: catalyzing fiduciaries to adapt from a bygone era of shareholder compliance and impotence to today's, when constructive stewardship is actionable.

Fiduciary Duty

Legal expectations of fiduciaries have fallen well behind changes in the capital markets. So a policy agenda to unlock prudent stewardship must consider reforms in this area. Otherwise the market risks living with standards baked into investor behavior that encourage owner passivity or myopia.

Groups such as the Aspen Institute's Business and Society Program, the CFA Institute, FairPensions, the Network for Sustainable Financial Markets and Tomorrow's Company have pioneered remedies. Prescriptions generally fall into the following categories:

Rediscovering the duty of impartiality. As we have seen, duties as now widely interpreted compel fiduciaries to adopt lemming behavior, often short term in nature. An antidote is to resurrect the key, but long-ignored, 'duty of impartiality', which obligates an institution to weigh the interests of different beneficiaries. The CFA Institute describes the duty this way: "engage in a delicate balancing act of taking sufficient risk to generate long-term returns high enough

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[55] Nell Minow. Testimony before the U.S. House Committee on Oversight and Government Reform, October 6, 2008.
[56] Some 900 institutions with more than USD30 trillion under management are signatories as of the first quarter of 2012. See www.unpri.org.
[57] The author is a nonexecutive director of Hermes EOS.
[58] See www.gmi3d.com/home.
[59] The Sydney-based Asset Owners Disclosure Project, which focuses on climate change risks, is an example of a grassroots advocate of fund transparency. See http://aodproject.net/.

to support real benefit increases for active participants who will become future beneficiaries, while avoiding a level of risk that jeopardizes the safety of the payments to existing pensioners."[60] In other words, combine patient capital with the need to make short-term payouts to retirees.[61] The duty of impartiality could theoretically emerge organically through the courts, if cases asserting breaches produce judgments that re-emphasize it. But most advocates believe the vacuum may require legislation or regulation.

Apply fiduciary duty to intermediaries. Statutes designed to safeguard retirement savings were designed well before today's complex market, where intermediaries with many functions touch on the value of fund member assets. Yet such middlemen normally do not fall under fiduciary duty standards applying to the home fund. So when they work for an asset owner, they have no obligation to do so in the ultimate interests of beneficiaries. John C. Bogle has long called for a fiduciary duty "establishing the basic principle that money managers are there to serve…those whose money they manage."[62] The US DOL is now considering whether to extend aspects of fiduciary duty to certain agents—but this, too, may require legislation.

Widen fiduciary duty to include extra-financial factors. Current legal counsel encourages fiduciaries to downplay the investment relevance of key corporate drivers of value and risk because they fall outside the bounds of traditional, narrow financial measurement. So long as these factors are excluded from generally accepted investment responsibilities at portfolio companies, mainstream funds will steer clear of them for fear of running afoul of law. Most, therefore, would not signal concern about them in engagements with corporate directors. FairPensions has drafted fiduciary language for UK pension fund trustees that would broadly match more expansive obligations now in place for corporate board members. Similar legislation or regulation may be considered in the US.

Public Policy

US regulation of investment today fails both corporations and savers. Oversight gaps opened over the years owing to tectonic shifts in the capital market have unintentionally enabled institutional shareholders to act short term even as their beneficiaries need them more than ever to behave long term. Several public

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[60] *Code of Conduct for Members of a Pension Scheme Governing Body*, CFA Institute Centre for Financial Market Integrity (May 2008), accessible at www.cfainstitute.org/learning/products/publications/ccb/Pages/ccb.v2008.n3.1.aspx.
[61] See James Hawley, Keith Johnson and Ed Waitzer, "Reclaiming Fiduciary Balance," *Rotman International Journal of Pension Management* Vol. 4 No. 2 (Fall 2011), accessible at www.reinhartlaw.com/Publications/Documents/art111020%20RIIS.pdf.
[62] Stephen Davis, Jon Lukomnik and David Pitt-Watson, "Active Shareowner Stewardship: A New Paradigm for Capitalism," *Rotman International Journal of Pension Management* Vol. 2 No. 2 (Fall 2009), accessible at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1493279.

policy steps, if implemented, have the potential to reverse course.

First comes a bedrock question: who should mind the industry? Oversight of long-term savings has become a regulatory orphan. The US Department of Labor, handed the job of supervising pension plans under the 1974 ERISA statute, is buffeted by politics. The agency is cosseted under Democratic administrations, starved under Republican ones, subject to budgetary torque where power is divided. In part for this reason, as we have seen, the DOL is an unreliable regulatory parent of retirement funds, particularly as the agency needs periodically to adapt to changing market realities. At the same time the SEC, now the default guardian of savings thanks to the rise of 401(k)s, has myriad other securities market priorities—and no specific mandate to look after retirement plans. Again, a flawed parent.

One of two remedies would appear sensible. One would be to pull supervision out of the DOL into an independent, less politically-charged agency dedicated to expanded oversight of long term savings. The UK's Pensions Regulator is such an approach.[63] Another less efficient but arguably more feasible option would be to create an independent overlay body charged with coordinating and harmonizing oversight of long term savings in concert with existing agencies. Such a body could draw from other federal models, such as the multi-agency Financial Stability Oversight Council or the Public Company Accounting Oversight Board. It could best address challenges if its structure included not only agency heads (as in the FSOC) but also individuals representing investing institutions (as in the PCAOB) and beneficiaries, who can supply continuing insight on market conditions. In either case, structural reform would aim to house coordinated regulation fit for purpose for today's investment savings environment.

Then comes the question of content. What supervisory steps would help propel ownership behavior more aligned with long term citizen shareholders—and more constructive for corporate America?

Regulators should require retirement savings plans and other asset owners to produce an annual 'nutrition label' of information on the six major governance and stewardship features noted above. Authorities can issue best-practice accountability principles to help frame such releases. Or regulators can press market participants to develop their own through a code that funds would have to apply, or explain why if they diverge. One model for fund governance is the guidance drafted in April 2012 by APRA, Australia's prudential regulator. Provisions set out the agency's expectations of fund board oversight in everything from fiduciary skills to portfolio manager compensation to whistleblower protection.[64] In the US, voluntary standards on fund governance were released the same month by the National Conference on Public Employee

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[63] See www.thepensionsregulator.gov.uk/index.aspx.

[64] See www.apra.gov.au/Super/PrudentialFramework/Documents/Draft-Prudential-Standard-SPS-510-Governance-(April-2012).pdf. The UK's Stewardship Code is a related model, but it focuses more on fund engagement with portfolio companies than own governance.

Retirement Systems, representing 500 funds with $3 trillion in assets.[65] Best practices for how institutions should use ownership tools at portfolio companies may be found in stewardship codes in the UK, the Netherlands and South Africa.[66] A market-based international version covering both fund governance and stewardship was developed by the International Corporate Governance Network.[67] And the Organisation for Economic Co-operation and Development produced broad principles of fund governance in 2009.[68]

Whichever model US regulators adapt, the needs of modern transparency dictate that disclosures opt for plain English over jargon. This isn't just cosmetic. The UK's NEST retirement system discovered through surveys that technical language was a barrier to communication with prospective members, so it developed a glossary of commonly understood pension terms to use.[69] US governance disclosures, similarly, should be accessible online and written for easy comprehension by beneficiaries. Further, like a food nutrition label, any data required should follow a common format, so that individuals can readily make comparisons between institutions. An SEC example shows what not to do; the Commission rightly required mutual funds to release their share voting records, but then gave no guidance about how funds should do it. Today the information is hard for investors to dig up and costly for analysts to put side by side.[70] Apps allow individuals using smart phones and tablets to compare doctors, restaurants, motor vehicles, tax regimes, retailers and countless other services. Disclosures should allow social media to give similar services to individuals trying to assess the quality of their savings arrangements.[71] Scholars would also benefit; there is a need for solid, accessible data on fund governance to advance research in the area.[72]

Regulators should also modernize fiduciary duty standards and apply them to intermediaries along the investment chain. In particular, they should make clear that voting proxies is not the only, or even always the most effective, expression of ownership. Agents responsible for long term assets should be expected to make use of any and all stewardship tools, including voting, so long as options are practical and available, to safeguard the savings of beneficiaries.

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[65] See http://www.ncpers.org/Files/2012_ncpers_best_governance_practices.pdf. See another set of best practice recommendations in the "Clapman Report" (Stanford Institutional Investors' Forum, 2007), accessible at http://www.directorsandboards.com/DBEBRIEFING/July2007/FundGovernanceReport.pdf.

[66] See the UK code at www.frc.org.uk/corporate/investorgovernance.cfm; the Dutch at www.eumedion.nl/en/public/knowledgenetwork/best-practices/best_practices-engaged-share-ownership.pdf; and South Africa's at www.iodsa.co.za/PRODUCTSSERVICES/KingIIIReportPapersGuidelines/CodeforResponsibleInvestinginSACRISA.aspx.

[67] See www.icgn.org/files/icgn_main/pdfs/best_practice/inst_share_responsibilities/2007_principles_on_institutional_shareholder_responsibilities.pdf

[68] *OECD Guidelines for Pension Fund Governance* (June 2009), accessible at www.oecd.org/dataoecd/18/52/34799965.pdf.

[69] See www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/NEST-phrasebook,PDF.pdf.

[70] Form N-PX, accessible at www.sec.gov/about/forms/formn-px.pdf.

[71] For example, see www.proxydemocracy.org.

[72] Heineman and Davis (2011).

Similarly, supervisors should clarify that fiduciary duty permits institutions to take extra-financial factors into account when making investment and ownership decisions. And a duty of impartiality is critical to curb short term decision-making at the expense of beneficiaries' with long term interests.

The US Sarbanes-Oxley Act set skill standards for members of corporate board audit committees. In a similar way, authorities should examine what expertise and independence fiduciary entities should feature to carry out investment responsibilities, including as responsive agents of beneficiaries and prudent owners of public corporations. The CFA Institute offers one version of guidance in this area through a "Pension Trustee Code of Conduct".[73] The UK Pensions Act, which set skill requirements, spawned a host of training, advisory and association initiatives aimed at improving trustee professionalism. Fiduciaries must be able to impose the interests of beneficiaries throughout the investment chain rather than be captured by advisors with other objectives.

Of course, these initiatives will fail to take hold if enforcement is lax, as it is today. Regulators should be on the beat, scrutinizing annual disclosure statements, testing whether fiduciaries are matching decisions to beneficiary interests, and checking if those tasked with overseeing plans know what they are doing. But supervision can be prophylactic, not just punitive. The Australian Treasury, for instance, provided start-up money for a Responsible Investment Academy, which now offers online training for asset managers in ownership skills.[74] In 2012 the European Commission provided similar funds for courses leading to certification in prudent ownership.[75] Public or semi-public bodies such as FINRA or the SEC could help stimulate training of fund trustees and asset managers as one means of instilling a culture of stewardship in investment.

Trying Ownership

If policy in recent decades has made corporations more a product of what their short-term owners allow them to be, systemic changes in company purpose can come about in one of two ways. Either policies aim to divorce boards from the sway of institutional investors, freeing directors to do what they think is best for companies. That is what aspects of the JOBS Act of 2012 started.

Or, policy can concentrate on measures to align investment agents with long-term beneficiaries, strip conflicts from the system, and discard obsolete investment practices for those matched to today's market realities. That agenda is based on the premise that impediments have long disabled the ability of most funds—with a handful of exceptions—to exercise stewardship.

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[73] See www.cfainstitute.org/ethics/codes/pension/Pages/index.aspx.
[74] See www.riacademy.org/.
[75] "European Commission Appoints ICGN, PRI and EFFAS to Build Capacity of Investors to Integrate ESG Information in Investment Decisions," *International Corporate Governance Network*, September 27, 2011. Available at www.icgn.org/press/item/1103-european-commission-appoints-icgn-pri-and-effas-to-build-capacity-of-investors-to-integrate-esg-information-in-investment-decisions.

Prudent ownership, in effect, has not really been widely tried yet, at least in the era when collective investment bodies have largely replaced controlling entrepreneurs. That circumstance implies, in turn, that the United States is harboring an under-powered capitalism: public corporations are pressed to put short term gain over long term value, and savers find themselves with less wealth than they should.

Corrections to the world of institutional investment carry the potential of giving corporate boardrooms both capital and a license to innovate, embrace appropriate risk, and address extra-financial drivers of value creation over the long term. The formula distills to this: reforms that put the interests of citizen-investors first hold out the prospect of making better citizens of corporations.

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