Shareholder Democracy:
The Roots of Activism and the Selection of Directors

Keynote Address

By

John H. Biggs

To

The Inaugural Conference

Of

The Loyola University Center for Integrated Risk Management and Corporate Governance

April 19, 2007
Shareholder Democracy: The Roots of Activism and the Selection of Directors

John H. Biggs

I have three related topics tonight which I hope will make a good lead-in to your conference on Integrated Risk Management and Corporate Governance.

First I’d like to give my view of the origin and inevitability of the greater shareholder activism that is currently emerging. Second I will briefly address a fundamental issue arising from the new shareholder activism, namely how directors of public companies are elected. Third, I will conclude with a description of a form of shareholder democracy and access used by TIAA-CREF from its founding in 1918 to its abandonment in 1988, ironically required by SEC regulations.

My conjecture is that shareholder activism is driven by a deep political change arising from the rapidly developing structure of private pension plans. That change is accelerating. And the director election process is exactly the type of issue that can galvanize for action a coalition of pension participants and investors. And finally the best solution will come from several years of corporate debate and negotiation, producing a creative solution that avoids the evils currently feared by management advocates. The SEC should permit shareholders proxy resolutions on the subject to go forward.

To illustrate the vigorous debate on these matters let me give you a few quotes from corporate leadership.
First, consider Martin Lipton’s keynote address on February 7, 2007 to the 25th Annual Institute on Federal Securities. That address had the ominous title the “Eclipse of the Public Corporation”. Mr. Lipton, one of the most distinguished and thoughtful corporate attorneys in the country, decries the “shift in the board’s role from guiding strategy and advising management to ensuring compliance and performing due diligence” A second concern was whether the new environments would make”directors and companies so risk averse that they lose the entrepreneurial spirit that has made American business great”. The drivers of his concerns are all the new regulations and, in his concluding sentence, “rampant, unrestrained and unregulated shareholder activism”.

Gretchen Morgenson in the New York Times, a few days later, described his talk under the headline “Memo to Shareholders: Shut Up”

Jack and Suzy Welch in the December 25, 2006 issue of Business Week are troubled by the lack of “constructive dialogue in the Board Room….Directors are too paranoid”.

Henry Manne, Dean Emeritus of the George Mason University School of Law, and an expert on the law and economics of markets and corporations, writes a long op-ed piece in the January 2, 2007 edition of the Wall Street Journal under the heading “The ‘Corporate Democracy’ Oxymoron”. He attacks vigorously the idea that the SEC might “facilitate direct shareholder nomination of directors”. He bases his argument on the assumption that activist investors are interested “in social causes, political movements or
the reallocation of wealth”, when they “should be interested exclusively in maximizing their return on investment”.

John Castellani, the savvy and experienced President of the Business Roundtable, in a memo dated January 20, 2007, warned that direct access to the ballot for board candidates “could fundamentally transform the way we do business in this country”. And direct access to the proxy” would turn corporate board rooms into battlegrounds for every political issue and agenda other than the long-term growth of the companies”, with “battles on every issue from genetically-engineered food to animal welfare standards”.

In its lead editorial on November 27, 2006 entitled “Board Games” the Wall Street Journal attacked the peculiar idea of “shareholder democracy” and direct access by any shareholders, large or small, to the director election process. They argue that the activist shareholders “tend to be union-dominated pension funds, with ambitions for turning board rooms into new political battle-grounds”.

In a March 2 op-ed piece in the Wall Street Journal, Tom Perkins, the legendary venture capitalist, contrasts how a venture capital board helps a company succeed, as compared to a public company board, busying itself with process, reviewing all actions of management—which he then calls a “Compliance Board” as opposed to a “Guidance Board”. He further slams the Compliance Board as “newly gender and racially inclusive”, “focused on legal issues” and “compliance with SEC, NYSE and Sarbanes Oxley”.
This is a serious set of warnings that should concern us in the rapidly changing corporate governance environment.

But, finally a quote from Peter Drucker in a book written in 1976, entitled *The Unseen Revolution: How Socialism Came to America*:

“If “socialism” is defined as “ownership” of the means of production by workers”—and this is both the orthodox and the only rigorous definition—then the United States is the first truly “socialist” country.”

In my remarks, I argue that the new activism is not exclusively from a bunch of union dominated, politicized pension funds but rather it gains its powerful thrust and scope from an extraordinary alliance of worker/employees and investors, represented by a broad array of institutional investors.

And I will also illustrate how one company, TIAA-CREF had an extraordinary economic success over a 70 year period, and arguably the most remarkable sustained growth of any financial institution in America. And it performed all that with regularly contested director elections, a gender and racially mixed board, and a non-profit charter thrown in to handicap it further. And it performed the results without a single acquisition.

Where did all this “rampant, unrestrained and unregulated activism” come from? I believe Marty Lipton mistakes a symptom for the cause in dating it from the founding of
ISS in 1985 by Bob Monks and Nell Minow, along with the emergence of CALPERS as an outspoken critic of corporate America.

I suggest the cause was rooted in the enactment of ERISA in 1976 where the seeds of death for Defined Benefit (DB) and the seeds for dramatic growth for Defined Contribution (DC) plans were sown. Along with heavy regulatory compliance, ERISA created the costly PBGC. Someone with perfect foresight could have seen that ERISA would have the unforeseen result ending employers sponsorship of DB plans.

Interestingly, one of the most keen observers of U.S. pensions, Peter Drucker, did not see that his pension socialism would never come to America with the predominance of DB plans. Such plans largely obscure the losses to individual participants due to the sponsors’ commitment to fund them. However ERISA also paved the way for a true revolution, in creating the IRA and making possible the subsequent spectacular growth of DC plans through the 401(k) mechanism. Over half of the 16 trillion dollar of pension savings are now in DC plans with IRA’s and 401(k)’s dominating with over $3 trillion in each on 12-31-2006. And there is no question that their growth will continue if not accelerate. Many predict this outcome being another unintended result of the harsh provisions of the Pension Protection Act of 2006.

The fundamental characteristic of IRA’s, 401(k)’s and other DC plans is that the worker/participant/family has a direct interest in the outcome of the plan’s investments.
And the stocks of public companies represent the core investment of almost all of such plans.

The PCAOB estimates that 55% of American families now own stock in public companies, mostly through their DC plans and IRA’s. Another large percentage own stocks through their state and municipal multi-employer plans where contributions, taxes and benefits are all determined, in great part, by the investment results of the stocks held in public companies.

Peter Drucker, writing in 1976, had no idea of what was coming. The simple change in structure of U.S. pensions would lead to a very different politics of workers in a strange alliance with investors.

Bob Monks and Nell Minow and CALPERS simply saw the roll for institutional investors before others. I’m pleased that TIAA-CREF also became at that time the first private institutional investor to begin challenging corporate America on a range of issues. As most of you know, TIAA-CREF is a DC plan, using section 403(b) of the IRS Code, with several million higher education employees. Those employees have had a significant amount of their pension assets invested in CREF stock accounts. We were the first institutional investor to publish in 1993 a statement on good corporate governance, with the specific purpose to explain how we would vote our proxies.
Consider the political power of 55% of American families having ownership in public companies. Didn’t that have something to do with the unanimous Senate vote passing Sarbanes-Oxley? After 55% of American families saw what happened to their investments after Enron, WorldCom and all the other scandals they lost faith in the integrity of all American companies. A harsh law was the result. The auditors paid most dearly, being the first major American profession to earn the privilege of having a federal regulator. Not yet for lawyers and doctors.

Besides direct political action in Congress the new coalition of workers and investors naturally results in increased shareholder activism as both workers and shareholders are energized by issues of common concern to both. For instance, currently they may see what they believe is an unfair capture of “rents” in the form of excessive management compensation, permitted by a lax board oversight.

One can imagine the energy such an issue would bring to the usual activists. The state pension systems would see plenty of political advantage in attacking this issue—whether in seeking shareholder advisory votes on compensation directly, or seeking ways to change the perceived laxness of the shareholder elected boards. The now widespread adoption of “majority voting” provision is an example of the results of this activism. Also, the issue of direct access to the proxy to create contested ballots is another.

Union pension plan activism was focused not long ago on local management issues, using the proxy mechanism for individual company harassment in support of
negotiations. They have now moved to more global issues as they join other pension plan activists in attacking matters that reflect the huge perceived gap in executive compensation and their members limited wage growth and reduced job security. They have added well versed lawyers to their staffs who understand SEC rules, corporate by-laws and the other various mechanisms of corporate governance.

Most recently the American Federation of State, City and Municipal Employees (AFSCME) sought to put a resolution on AIG’s proxy statement asking the company to permit direct access to the ballot by shareholders in director elections. Rebuffed by management, who were supported by the SEC, the union took their argument to the courts where they won.

The SEC and corporate America realize the potency of this issue and hence the strength of concern expressed at the beginning of this address. One would have suspected that a conservative, more business oriented SEC would be immediately sympathetic to the corporate arguments. However, they have hesitated to take up the matter. The SEC’s caution with this issue seems to me to be a growing recognition of the political clout of a coalition of shareholders joined with the 55% of American families whose pensions are directly affected by corporate performance.

More significantly, this is exactly the kind of issue that can bring out investor oriented institutions such as mutual fund companies that invest 401(k)’s and IRA savings, the hedge funds that are steadily gaining more pension investors. Incidentally the hedge fund
role in pension fund investing was expanded by Congress in the recently enacted Pension Protection Act of 2006.

The self appointing character of how directors of public companies are elected has long been an awkward matter for boards to explain, in view of the perceived democratic process that shareholder ownership suggests. The single slate of directors to “choose” from doesn’t square with Americans’ idea of democracy. The legitimacy of American companies is crucial to their franchise and academic arguments like Henry Manne’s calling corporate democracy’ an oxymoron simply won’t sell—they seem specious and tortured.

Yet, I know of no one in the corporate world who think direct access to the proxy by shareholders is anything but a serious threat to good corporate governance. The arguments against are articulated in my earlier quotes: “social agendas will be pursued” “a minority will control the board”, “it will be the end of collegiality”. Other arguments I have heard often include: from respected leaders in governance and finance “I would not be willing to run in a contested election”, and “our already weakened defenses against inappropriate takeover attempts would be lost”.

What interests me is how such a contested election would actually work. What would the proxy ballot look like? Would the directors list the names they recommend and then the shareholders their name(s)? And then those elected would be on a simple plurality basis?
Or would there be entire slates? And of course the really hard question is how to select the shareholders eligible to put names in play.

As you probably know, the SEC several years ago proposed a way for institutional shareholders to nominate a director or directors. The proposal was controversial and had so much opposition that it was finally dropped.

The AFSCME proposal is to permit director election procedures to be placed on proxies on a precatory basis—not to actually force companies to take an action. Without dictating one solution, this can create a climate for discovery of a reasonable one. We have some good examples of imaginative corporate secretaries and their corporate lawyers finding compromises to difficult questions like direct access. Majority voting is an excellent example.

One would hope the SEC would permit the debate to go on for a few years in the expectation that a liveable solution will be found.

But let me describe one imaginative and successful way contested ballots did work, at TIAA-CREF, from it implementation in 1922 (but planned in the 1918 founding documents of the company) to 1988.

My information for the TIAA-CREF contested ballot process comes from a history of the company written by William Greenough, a former long-term CEO, entitled It’s My
Retirement Money: Take Good Care of It. Bill is best known for his invention of the variable annuity, CREF, which has made retirement for thousand of professors prosperous well beyond their expectations.

The founders of TIAA in 1918 wanted some true policyholder democracy in the election of, at least, some of the trustees—in contrast to the typical single, unopposed slate of most commercial companies. To do so they set up a free-standing Policyholder Nominating Committee, original appointed by the Board of 16 trustees who were named by the organizing entity, the Carnegie Corporation and renewed through the usual self-selection or single slate process. The Policyholder Nominating Committee also became a self-selecting entity but independent of the other trustees.

Starting in 1921 the Committee nominated each year 5 candidates, primarily from higher education, and one of them was elected by weighted voting (5 points for first preference, 3 for second and one for third). Since trustees were elected for 4 years, eventually 4 sitting trustees of 20 were so elected. There were 69 policyholder selected trustees over the lifetime of the Policyholder Nominating Committee. Subsequently, with the creation of CREF as a separate company, the system was modified to nominate 3 trustees for each board with one to be elected.

A surprisingly large number of TIAA, and later CREF, participants actually voted, ranging from 8 to 30%, far higher then the less than 1% who voted for mutual life insurance company single slate directors.
I recall from my own experience that several trustees so elected came in hostile to the policies of the company but quickly became good colleagues of the other trustees and advocates for the company. Perhaps the most distinguished of such “initially hostile” trustees was Paul Samuelson, who was elected after a bad patch of investment performance. Paul was renewed for multiple terms until he retired because of hitting the mandatory retirement age. He turned out to be the leader in shaping the company’s investment policies in the 1970’s and 80’s.

After CREF was formed, 5 Nobel Laureates and a number of other distinguished economists came on the Boards through the Policyholder Committee process. Some of them were not easy board members—some Nobelists have a hard time understanding the word “collegial”. But they all contributed to the remarkable progress and growth of the company.

Since CREF was created before there was established law on whether a variable annuity was an “insurance contract” subject to state law, or a “security” subject to the federal security laws, the SEC exempted it from compliance with the Investment Company Act of 1940. For a variety of reasons the company agreed to submit to SEC regulation in the mid 1980’s and, ironically, the Policyholder Nominating Committee violated the direct voting requirement by shareholders, a requirement embedded deep in SEC regulations and interpretations.
Briefly, TIAA-CREF’s financial success in the period of this practice was extraordinary. By 1988 the assets of the combined entities, for both TIAA and for CREF, exceeded the life insurance assets for any other company in the U.S. The company first applied for credit ratings in 1990 and easily earned Triple A ratings from all the agencies.

Yet TIAA-CREF was a narrowly focused company with one set of products, and restricted severely by its tax exemption to one market, higher education. Critics of non-profit cultures, of large and well-diversified boards, with true shareholder-elected boards have to describe TIAA-CREF as an outlier. But is it really?

Bill Greenough and his successor CEO’s can testify to the vitality and energy brought to the company by its independently selected trustees. There might even be an upside for corporate America if they found a similar way to inject new ideas and new talent into their boards.

My thesis is simple: the new direct structure of pension plan ownership has brought a peculiar form of Peter Drucker’s socialism to America, and it is expressing itself in the new shareholder activism. The inevitable focus of this new coalition of workers and investors will be the performance of management and the boards of directors. Inevitably the way that directors are selected for the board will change. One can hope that the SEC will let this new selection process develop in a way that ingenious solutions can be found that will accommodate the legitimate economic concerns of corporate leadership.