A Comparison of the Attitudes of Public Pension Sponsors and Corporate CEOs Regarding Issues of Corporate Governance

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ABSTRACT

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This dissertation contrasts the attitudes and beliefs of corporate CEOs and public pension plan sponsors regarding proposals commonly made to better corporate governance practices. It examines questionnaire responses to a survey sent to public pension funds with 1994 assets of $1 billion or more and corporations randomly selected from the Standard & Poors 500 and Midcap 400 indexes.

The research examines the asset growth of public pension plans and the effect that growth has had on their advocacy of corporate governance reform. It notes the more common governance proposals and uses the literature to predict CEO and Plan Sponsor attitudes regarding their possible adoption.

While there have been studies that report the number of companies that exhibit specific governance practices, and relate those practices to corporate financial performance, there are no studies that compile, analyze, and contrast the expressed attitudes of corporate CEOs and public pension plan sponsors on issues of corporate governance.

Eleven hypotheses are tested using nonparametric statistical techniques. Survey respondents consisted of 68 Plan Sponsors (response rate of 57.6%) and 61 CEOs (response rate of 20.3%). The inclusion of open-ended questions provides an opportunity for readers to gain additional insights into the data.

Results indicate higher levels of receptivity from CEOs to corporate governance proposals than was anticipated. Opportunities for collaborative action by public pension plan sponsors is shown to be currently limited by the diversity of opinion within the group about what constitutes appropriate levels of governance activism.

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I dedicate this work to my wife, Marcelina. Her love and unwavering support got me through those times when completion of the research seemed most difficult. She never lost hope, and therefore, neither did I.

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CHAPTER 1

INTRODUCTION

Historically, from the earliest examples of American corporate finance, investors have sought influence within the corporations they financed. This practice diminished with the emergence of professional managers and the dispersion of stock holdings across millions of individual investors. However, in light of the emergence of institutional investors as dominant forces in the marketplace, the question of who owns the public corporation has taken on new importance.

This study questioned one group of major institutional investors, pension plan sponsors[1], and contrasts their beliefs about issues of corporate governance with the viewpoints of CEOs who lead the companies they invest in. It points out many areas of agreement, and in some cases, issues of attitudinal difference.

1 "Pension Sponsor" is the term used to designate the entity with ultimate administrative, legal, and fiduciary responsibility for a pension fund. Sponsors may, or may not, choose to engage advisors to assist them with investments and/or reporting responsibilities.

There have been few surveys of CEOs regarding their attitudes about corporate governance proposals. Surveys collecting information about corporate governance primarily extract data about the current state of corporate practice. They reveal little about the underlying attitudes and beliefs of management.[2] The author has been unable to find any study that contrasts CEO attitudes with those of pension plan sponsors.

One recent study does report the views of institutional investors on several governance issues.[3] In a survey of 231 large shareholders conducted by Wirthlin Worldwide, and sponsored by Russell Reynolds Associates, institutional investors reported attitudes about board and CEO compensation, as well as about the qualities they are looking for in board members. The group surveyed was a broad group of money managers at mutual funds and investment banks, with a small number of corporate and public pension fund managers included.

As described within Chapter two, Drucker and others have noted that pension funds, particularly *public* pension funds (pensions sponsored by

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[2] For example, see The 1995 Corporate Governance Survey. National Association of Corporate Directors. 1995. Washington, DC. It is important to note that this effort, conducted by the National Association of Corporate Directors and sponsored by Deloitte & Touche LLP, achieved only an 8% response rate and primarily collected data about current practice.

[3] Dobrzynski, Judith. "Big Investors Train Their Fire On Nonperforming Directors." NY Times, March 7. 1997, p. D6.

government for the benefit of public sector employees), are unique from other institutional investors.[4] Because they are created as an act of public policy, and represent the public sector, they have closer ties to government than other corporate stakeholders. Isolated from redemption pressures, the funds can actuarily predict their cash flow needs decades in advance, thus enabling them to take a longterm view. Additionally, the $100 billion asset size of some of the larger public funds makes their security holdings somewhat more illiquid than many other institutions.

As pension funds grew exponentially in terms of assets under management, the entire relationship between the funds and the companies that they "own" as shareholders has changed. Finding it difficult to follow "the Wall Street Rule" (which held that if investors were dissatisfied with a company's performance or practices they should sell the stock), pension sponsors adopted a more active mode of share ownership.

Resisting the more confrontational methods of corporate activism, most pension funds have sought to influence companies through negotiation and public posturing. A fund can apply pressure to a CEO by identifying a company as structurally flawed or underperforming. Reflecting their strength, the funds find

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[4] Drucker, Peter. "The Governance of Corporations." In Managing For The Future, pp. 236-237. 1st ed., New York: Truman Talley/Dutton, 1992.

that many companies will work with them to resolve issues rather than risk public confrontation.

Four popular governance proposals have received particular attention in the academic and investment communities:

- Separation of the CEO and Chairman positions;
- Appointment of a lead director where the Chairman and Chief Executive are the same person;
- Expanding the influence of outside directors and shifting the balance of power between management and the board; and
- Providing the public pension funds and other institutional investors with opportunities for input that are consistent with their role as long-term owners.

These issues became the focal point of the beliefs that CEOs and pension plan sponsors were queried about. Chapter 3 presents eleven hypotheses tested by the research as an outgrowth of these broad governance proposals.

Chapter 4 describes the methodology utilized to collect data. The research design involved the completion of survey instruments by (a) sponsors of public pension plans with over $1 billion in assets under management and (b) Chief Executive Officers of S&P 500/S&P Midcap corporations. Nonparametric multivariate statistical techniques were used to determine the similarities and differences in expressed attitudes between the two groups.

Chapter 5 presents the results of the survey sent to 118 public pension plan sponsors and 300 Chief Executives of S&P 500 and S&P 400 (midcap) firms. A response rate of 57.6% was achieved by the survey of the plan sponsors. Sixty-one CEOs (20.3% of the sample) responded to the survey.

Chapter 6 discusses the results and identifies several limitations of the study. For example, while the survey presents the views of two groups at a specific point in time, those views may change and thus limit the long-term use of the research. Nonetheless, the research provides a look at the attitudes of two groups that are currently negotiating the limits of their power and control over America's business corporations. It serves to provide new information about which governance proposals may prospectively receive acceptance or rejection in the executive suite. It recounts differing views of the influence and role of boards of directors. Also, the research reveals intragroup differences in attitude which affect their solidarity, and hence, their influence. The study concludes with recommendations for future research.

CHAPTER 2

REVIEW OF THE LITERATURE

The Chartering Of Corporations

The government of the United States was born of a revolution, and has been shaped by a Constitution based on the concepts of representation and democracy. Not all of society's powerful institutions are expected to adhere to these standards - clearly the military is not meant to be a pure democracy. But what are the expectations for America's corporations?

The question is not an insignificant one. The size and influence of transnational companies are seen by some observers as pervasive:

> "Corporate managers now have more power than most sovereign governments to determine where people will live; what work they will do if any; what they will eat, drink, and wear; what sorts of knowledge they will encourage; and what kind of society their children will inherit. Now, with multi-national corporations larger in assets and population than many countries, we have no clear answer to the question--to whom are those who control these great enterprises accountable? In theory, the owners, the holders of equity securities and the government, representing the society as a whole, play that role. The basic framework is a matter of the law established by the legislature of the company's domicile. But the company's managers can choose virtually any place for domicile no matter where

> the corporation actually resides or operates. An international "race to the bottom" is the result."[5]

The earliest U.S. corporations received their charters only through negotiation and a subsequent special act of the state legislature. In 1811, New York State created a formal process through the enactment of a general incorporation statute. Sensing a new revenue generating activity, other states shortly followed suit, and competition developed between states for the revenues associated with incorporation. Today, as a result of a favorable corporate tax structure and greater liability protection, most American corporations--regardless of actual location--are registered in Delaware. One uniform component of virtually every state statute was the requirement of a Board of Directors as the decision-making instrument of a corporation.

The Historical Role of Outside Investors

Historically, outside investors have sought representation within the corporations they financed. Perhaps the earliest example of formal "outside" representation was the currency-issuing Bank of The United States. In the early 1800's, the Bank of the United States was originally chartered as a private

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[5] Monks, Robert A. G. Corporate Governance In The Twenty-First Century: A Preliminary Outline. Lens Inc., 1995. Internet.

corporation. In the interest of equitable representation, the U.S. government was granted the right to appoint five of the bank's twenty-five directors.[6]

Most firms met their capital needs through investments by the venture capitalists of the day - Morgan, Carnegie, etc. JP Morgan (the elder) was particularly interested in assuring his access to corporate information and decision-making within the companies he invested in. In addition to the standard financier practice of placing representatives on the boards of the railroads to which he made loans, he is credited with applying the pressure to assure the first issuance of a public accountant certified financial statement issued by a public company (General Electric, 1898).[7]

Through the 1800's and continuing in some form today, capital needs of a growing business have often been met by lenders requesting a seat on the board as part of their lending terms. Equity issued as private placements to finance expansion has often brought insurance companies, venture capitalists, or private trust managers to the board.[8]

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[6] Ibid.

[7] Lynch, J. M. (1979) Activating The Board of Directors: A Study of The Process of Increasing Board Effectiveness. Dissertation, Harvard.

[8] Sloan, Alfred. My Years With General Motors. New York: Macfadden-Bartell, 1965.

A well known, and early example of investor influence is the case of General Motors. In 1920, a series of strategic and financial blunders sent General Motors' stock price tumbling. Its largest shareholder, Pierre S. Du Pont, Chairman of Dupont Chemical (which held nearly 25% of GM's outstanding shares) placed great pressure on the company. He accepted the resignation of GM President and Founder William Durant and assumed GM's Presidency himself. After three years in the role, he handed control of the company to Alfred P. Sloan.[9]

As corporations grew, their capital needs could rarely be satisfied by one owner or a small group of owners. In 1933, Berle and Means noted that the legal owners (shareholders) had become divorced from the control of the corporations they invested in. Professional managers had assumed the traditional roles of ownership. As the authors stated, "In crude summation, most owners own stock, insurance savings and the like and do not manage; most managers (corporate administrators) do not own."[10]

Peter Drucker discussed the significance of this change in the role of corporate ownership:

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[9] Taylor, William. "Can Big Owners Make A Big Difference?" Harvard Business Review (Sep/Oct 1990): p. 70.

[10] Berle, Adolf A. and Gardiner C. Means. The Modern Corporation and Private Property. New York: Harcourt, Brace & World, Inc., 1932.

"In 1933, Adolph A. Berle, Jr. And Gardiner C. Means published *The Modern Corporation and Public Property,* arguably the most influential book in U.S. business history. They showed that the traditional owners, the nineteenth-century capitalists, had disappeared, with the title of ownership shifting rapidly to faceless multitudes of investors without interest in or commitment to the company and concerned only with short-term gains. As a result, they argued, ownership was becoming divorced from control and a mere legal fiction, with management becoming accountable to no one and for nothing."[11]

John Kenneth Galbraith recounts in The New Industrial State his reaction to the 1956 annual Bethlehem Steel shareholder meeting and subsequent negotiations to publish his account in IBM's internal magazine, Think:

"[I wrote to IBM] During the proceedings, as in the report, there are repetitive references to *your* company. Officers listen, with every evidence of attention, to highly irrelevant suggestions of wholly uninformed participants and assure them that these will be considered with the greatest care. Women stockholders in print dresses, who own ten shares, give votes of thanks 'for the excellent skill with which you run our company,' and these are received by the management with well-simulated gratitude. All present show stern disapproval of critics and especially of those who use the occasion to attack the social, political or military activities of the firm. No important stockholders are present. No decisions are taken. The annual meeting of the large American corporation is perhaps our most elaborate exercise in popular illusion.

[I was told that the editors of Think initially planned to publish this account of the Bethlehem Steel shareholder meeting.] However, it did not appear in the magazine. They later explained that, while the truth of the case was not in question, to inform their stockholders, as would this chapter, that they had no power would not be couth."[12]

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[11] Drucker (1992), p. 249-250.

[12] Galbraith, John Kenneth. The New Industrial State. Second ed., Boston: Houghton Mifflin, 1978.

The separation of ownership from management and the continued growth of the capital needs of companies spawned an evolutionary change in the role of the chief executive. An increase in the size and complexity of business gave rise to the need for an increasingly sophisticated and professional manager. In short, as companies matured their capital needs led to changes in the relationship between owners and managers. Levy notes that these changes began to be reflected through the title generally granted to a chief executive.

> "Until the period between the two World Wars, today's largest corporations typically had neither a chairman nor a chief executive officer, but one person whose only title was that of president. Between 1910-1935, the title of chief executive officer was probably first granted to establish the president's increasing power in a period when that was crucial to organizational growth. Many presidents fought to establish primacy over their own senior managers. In addition, presidents often had to raise outside money to finance growth, without ceding control to financial suppliers.
>
> Following World War II, the titles of chairman and CEO were frequently combined in one person, possibly in recognition of the extremely strong position of the CEO. That remains the dominant practice in the United States today in large, public companies. What it now means to be chief executive, while still somewhat unsettled, is much clearer than what it means to be chairman, and the title of CEO connotes considerable power, while that of chairman does not."[13]

Similarly, the separation of management from ownership spawned a change in the role of the board:

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[13] Levy, Leslie. Separate Chairmen of the Board: Their Roles, Legal Liabilities, and Compensation. Institute for Research on Boards of Directors, Inc., 1993. Research Report 1

"There is an evolution that changes the board from an integrating device for the two views of the owner-managers, to an interface where the owners and managers meet, to an intermediary acting for the owners, and ultimately, in the case of the large organization, to an independent entity acting--in theory--as the owners, juxtaposed between the corporation and the multiplicity of audiences interested in or affected by the corporation--shareholders, employees, consumers, suppliers, competitors, legislators, regulators and neighbors. Some, in fact, end up as sounding boards for the executive, rather than as separate independent entities...The fractionalizing of ownership through sale or inheritance, and the addition of new owners in response to capital needs or through mergers, leads to what Eugene Rostow termed, the endocratic corporation, one whose stock is scattered in small fractions among thousands of stockholders"[14]

Levy charted changes in the titles of top corporate managers as a company evolves through various stages. The changes and patterns identified by Dr. Levy are shown in Table 1.[15]

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[14] Lynch (1979), p.22-23.

[15] Levy (1993).

Table 1
Common Patterns In A Corporation's Development

	Chairman	**CEO**	**President**
STAGE 1 Founder owns most or all of stock	Founder may be chairman, or title may be unused.	Title often unused.	Founder may be president, but not if someone else is CEO.
STAGE 2 Founder may own a significant portion of stock, but outside funding sources have been brought in to finance growth and also own significant amounts.	Founder or venture capitalist may be Chairman or title may be unused.	Founder or someone else may be CEO, or title may be unused.	Can be founder or member of founding family. Often is a professional manager in line to succeed the CEO.
STAGE 3 Widely disseminated stock. Major investors own too little to exercise substantial influence over decision-making.	Usually chairman is also CEO, except in transition situations involving normal succession, crisis response, or merger/acquisition.	CEO is a manager who owns only a small percentage of the company's shares as a limited percent of his own wealth.	The chairman and CEO may also be president, or the president may be someone else who is a candidate to succeed the CEO.
STAGE 4 Widely disseminated stock, except that institutional holders own a significant amount of stock	Same as stage 3, unless pressure is brought to bear on a separation of the chairman/CEO	Same as stage 3, unless pressure is brought to bear on a separation of the chairman/CEO	Same as stage 3

The Concentration Of Ownership In Institutions

In 1970, pension funds owned 17.5 percent of all publicly traded stock.[16] By 1994, the pension systems had grown to $4.6 trillion of assets, institutional investors

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16 Judge Jr., William Q. and Carl P. Zeithaml. "Institutional and Strategic Choice Perspectives on Board Involvement In The Strategic Decision Process." Academy of Management Journal 35 (4 1992): pp. 768.

owned 55.8 percent of the equity of the 1000 largest US corporations, and accounted for 80 percent of all equity trading.[17] Drucker notes:

> "Still largely overlooked, pension funds hold 40 percent or so of the medium-term and long-term debt of the country's bigger companies. Thus these institutions have become corporate America's largest lenders as well as its largest owners. As the finance texts have stressed for years, the power of the lender is as great as the power of the owner - sometimes greater." [18]

This unprecedented (within the U.S. markets) growth in asset concentration within one segment of the investment community has broad implications on the functioning of the equity markets and has resulted in new pressures for governance reform from a newly empowered group of stakeholders.

The process of increased activism was a gradual one that in the early stages (1960s to the 1980s) of institutional growth created institutional reactions which are diametrically opposed to those held by those same institutions today. In the early stages, institutional funds management was characterized by mobility. In particular, the "Wall Street Rule" was a popular maxim which held that if investors were dissatisfied with a company's management, they should "vote with their feet" by moving their investment elsewhere. Donaldson describes the initial stages of institutional stock ownership:

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[17] Minow, Nell. "Corporate Governance and Pension Plans." In Positioning Pensions for the Year 2000. Conference proceedings:Univ. of Penn., Lens Inc. 1995.

[18] Drucker (1992), pp. 236-237.

"In the 1960s, chief executives could still legitimately lay claim to a substantial body of 'loyal' stockholders whose equity holdings consisted of a small number of personally selected corporations in which they invested for the long term. These were the folks to whom the annual report could be dedicated with reciprocal and heartfelt loyalty since they represented an equity interest identical to that of senior management - undiversified and immobile.

However, the race was on among a new breed of mutual fund managers to win the minds, if not the hearts, of the public investor to a new concept of wealth maximization and risk minimization in the diversified portfolio. By the early 1970s, investment institutions (mutual and pension funds) generally held a large and growing fraction of the equities of major public corporations. The portfolio manager was a radically different shareholder from the dedicated individual shareholder. Drawing on the enormous potential of a broad, deep, and relatively efficient national and international capital market, the portfolio manager moved resources freely across the full range of corporate equities, loyal only to the goal of improving portfolio performance. The typical shareholder in the 1970s and 1980s was, unlike the typical jobholder, highly mobile and highly diversified...

The public shareholder with access to a well-organized capital market, minimized the cost of real or perceived mismanagement by the quick and certain process of selling the stock rather than by the long and highly uncertain process of attempting to change management behavior...The growing number of potentially influential portfolio managers who were judged by year-to-year performance found selling the stock the only practical way to maximize return or to minimize the cost of investment error."[19]

This development is what made possible the financial restructuring that took place during the 1970s and 1980s. Drucker draws the parallel between the power granted to the institutions and their increase in assets:

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[19] Donaldson, Gordon. Corporate Restructuring. 1st ed., Boston: Harvard Business School Press, 1994.