“The End of the Beginning”

My Friends,

A little over 70 years ago, a million Londoners took to the streets of this great city to celebrate the end of World War II in Europe. For people of my generation — those of us old enough to remember what became known in the United States as VE Day — nothing can ever compare to the horror of those war years. To even attempt to do so is banal. Yet there is much about the task facing us today that puts me in mind of the challenges and high stakes of that long-ago time.

Then, the rich self-rule traditions born and nurtured at Runnymede, at Valley Forge, in the barricades of Paris and elsewhere hung in the balance. Hitler’s Germany was many evils, but among them were a contempt for democracy, the appropriation of sweeping executive powers, and the intimidation of press and public, coupled with grandiose visions and a wayward moral compass. Unaccountable corporate power, I contend, has brought us perilously close to a similar situation in America today.

This, of course, is not the way things were meant to be. Just as the American political system is legitimated by a belief in the sanctity of the ballot, so the American corporate system, which vests control largely in the hands of privately appointed managers, is legitimated on three major bases. The first is a belief that the shareholders, as the owners of the corporation, have the ultimate right to control it. The second is a belief that corporate managers are accountable for their performance. The third is a belief that placing control of the factors of production and distribution in the hands of privately appointed corporate managers, who are accountable for their performance and who act in the interest and are subject to the ultimate control of those who own the corporation, achieves a more efficient utilization of economic resources than that achievable under alternative economic systems.[1]

[1] Melvin Aron Eisenberg

In both instances, if you dilute or strip away the foundational beliefs, the legitimacy inevitably begins to collapse. I'll talk later about the political system, but about the corporate system there can be little doubt.

Why that is so I will be detailing in the time allotted me today. First, though, let me say that I am here today more as Winston Churchill than as Jeremiah. On November 10, 1942, two and a half years before he announced the German surrender to his countrymen, Churchill delivered yet another memorable speech at the Lord Mayor's Day Luncheon at London's Mansion House. Rommel had been defeated in the African desert. America had joined the fray. Germany was not yet on its heels, but as happens so often in sports contests, the momentum had shifted in a subtle, subterranean way. "Now, this is not the end," Churchill cautioned. "It is not even the beginning of the end. But it is, perhaps, the end of the beginning." And he was dead-on right.

I've titled this speech "The End of the Beginning" in Winston Churchill's honor and, more important, in yours. All of you here today have good reason to be proud of what you have accomplished over the last twenty years against an implacable foe. In the simplest terms, you have made corporate governance a legitimate subject for discussion; you have defined the issues and generated increasingly sophisticated codes of conduct to inform global enterprise. Beyond that, the great institutions have educated themselves as to how they can best discharge their responsibilities as stewards, how they can responsibly act as activist shareholders and how they can hold managements to account. Peter Butler at Hermes has modeled for us all. We also have witnessed that skilled and persistent activists are welcomed on the best corporate boards even as Chairman – think of Ralph Whitworth at Hewlett Packard.

Clearly, we are ready to advance, but clearly, we also have far to go. We have barely begun the process of persuading managements that their best interests lie in encouraging a system of involved and effective ownership. Until we can achieve this objective, full success will elude our efforts. Our reality checks are not geographic progress but institutional ones. How far we have to go can most pertinently be understood through the lens of executive compensation. The persistent increases disconnected from any objective measures are an ugly and well-recognized part of our culture – and a major contributor to broader economic and social problems of inequality.

We need go further and witness how the commitment of Western countries to provide employer-financed pensions has been destroyed – with little notice. There are today virtually no companies offering "genuine pensions" in the sense that a return is guaranteed by their employer or the government. Managements posted immediate profit from abolishing the so-called defined plans, while transferring risk of loss from those most able to overcome it to those least able to, the employees themselves. Worse by far, too many CEOs and their top lieutenants have simultaneously feathered their own nests with executive pensions generous beyond all measure, and far beyond any real need. This huge transfer of wealth stands on its head the old and vital balance between management and worker compensation, with potentially dire social consequences.

Corporate language and priorities have captured the American Republic. The allocation of government resources is directed by the imperatives of short-term profit maximization and by a vocabulary of cost/benefit rather than or concern for flesh and blood citizens. While we watched, chief executive officers have acquired autocratic control of the levers of corporate power, which in turn has given them accelerating political power. They are accountable to no one as they direct lobbying and the "legal corruption" of sponsoring political conventions, inaugurations, Presidential debates, and congressional self-monuments, not to mention the "bread and butter" of political campaigns.

More alarming still, these lobbying efforts are increasingly "off the books." One might take heart in the fact that the number of registered lobbyists in Washington, D.C., has actually declined in recent years — until one realizes that the amount spent on lobbying has grown dramatically thanks to an ever-expanding network of stealth lobbyists taking advantage of ever-weakening lobbying regulations. This has been nowhere more true than in the finance, insurance, and real-estate sector, which has spent somewhere between $450 million and half a billion dollars annually on lobbying ever since the finance-sector driven crisis of 2007-08. Not coincidentally, one suspects, not a single high-ranking executive of any major finance firm has yet been prosecuted for malfeasances that rocked the entire global financial structure, but that is the subject of another discussion.

Suffice it for now to note that, while ownership has awakened to the challenge, CEO accountability remains largely a myth. Shareholders can neither nominate, remove, nor communicate with directors. The tendency is for the largest corporations to become “drones” in the sense of having no effective owners – that is no owner with more than ten percent of the total. What’s more, ownership increasingly is represented by index and algorithm selection in which human decisions as to purchase and sale of particular companies have no relevance. As one might expect, drone corporations on the whole pay fewer taxes, incur larger criminal fines, reward their CEOs with higher compensation, and externalize more liabilities on to society than do corporations having effective owners. That latter point, by the way, includes externalizing onto shareholders fines sometimes in the billions of dollars imposed in civil actions undertaken as the direct result of management actions.

Eighty years ago, Adolphe A. Berle warned that granting management free rein brought with it “the corresponding danger of a corporate oligarchy coupled with the probability of an era of corporate plundering.” Today, this corporate “capture” has found its fullest expression in the decision of the United States Supreme Court in <u>Citizens United</u>. That a Supreme Court Justice could actually argue, as Anthony Kennedy did, that there exists “little evidence of abuse that cannot be corrected by shareholders through the procedures of corporate democracy” shows how far we have sunk into a Never-Never Land of convenient “truths” and rosy shibboleths.

Instead of corporate governance, we have devised a kind of shadow play – Kabuki — in which the various constituents act out their assigned roles, culminating in the Kabuki festival we know as the annual meeting. Even shareholder activism, rather than undermining the legitimacy of the current systems, serves a legitimating function at these yearly events by maintaining the illusion that reform for the better is possible and that shareholders have power.

The endless proposals asking for actions to be subject to shareholder consent have not progressed from Melvin Eisenberg's classic judgment: "[U]nder current law and practice, shareholder consent to rules proposed by top management in publicly held corporations may be either nominal, tainted by a conflict of interest, coerced or impoverished. . . . Under prevailing conditions, however, the limits on the meaningfulness of shareholder consent are so substantial that allowing those rules to be determined or materially varied by top managers with shareholder approval often would be functionally equivalent to allowing those rules to be unilaterally determined or materially varied by top managers." And yet — more Kabuki —we continue to keep score of proxy contexts and votes as if important issues were in play.

The same can be said of shareholder access to the company proxy for nominations to the board of directors. Here is the *drole de guerre* in all its glory – words like *nominate, elect*, and *vote* are used for a process that virtually always results in the election of those individuals whose names are on the proxy card, printed and distributed at shareholder expense, but selected entirely by the incumbents.

Similarly, words and phrases like *trustee* and *fiduciary obligation* are promiscuously elicited to describe the functional responsibility of the CEO and board members under circumstances in which their pervasive conflicts of interest are manifest. It is almost as if we dumbly recite the words in denial of the certainty that they will have no effect.

What George Orwell wrote of Political Speak is equally true of Corporate Speak: They are both "largely the defense of the indefensible. . . . A mass of Latin words falls upon the facts like soft snow, blurring the outline and covering up all the details. The great enemy of clear language is insincerity."

By this time, you must be wondering – what is this all about? Where is he taking us? We now have been confronted with the reality that all manner of professionals are conducting serious discussions about corporate governance and arriving at conclusions based on plainly erroneous understanding of key concepts. Is this just an accident? Is everybody being careless? Is this "equilibrium of misconception" accepted because it provides something of value to the principally interested parties?

Institutional shareholders can claim to their beneficiaries that they are monitoring trust assets. Corporate directors can solemnly aver that they are subject to excruciating oversight (all of which justifies their otherwise incomprehensibly large fees). And corporate managers can assign professional advisors to play their roles in this Kabuki drama, all the while unthreatened in their virtually absolute control of the corporate assets and direction. Is there an organizing mind that profits from this confusion and engenders its continuance? Is the corporate governance industry a high profile "smoke screen" that enables the present composition of corporate power – hegemony of the CEO?

Answering these questions is the legacy of this speech. All I will say now is – it didn't get this way by chance, and it won't be changed by a simple laying on of hands.

The inescapable fact is that corporations cannot be effectively monitored or controlled by elements external to the corporation. Simply, corporations can lobby more effectively, can hire better lawyers to control the process of converting laws into public policy, and now — thanks to *Citizens United* — can commit almost limitless corporate funds to turning the political process in their favor. As Louis Brandeis once put it: "We believe that no method of regulation ever has been or can be devised to remove the menace inherent in private monopoly and overweening commercial power." The only internal component of the corporate system with power, motivation, and interest sufficient to act as an effective monitor is the ownership.

Here, though, we do have models to build on. Wars produce unlikely heroes — the meek private who storms an enemy bunker. I don't put Carl Icahn in that category. Meek he is not, and self-interest enters freely into his calculations. But Carl has shown repeatedly that a single activist using his own long-term money can generate long and short term results, and in doing so, he has offered both compelling evidence that responsible, active involvement is the key to superlative investment performance and shown the way for a generation of imitators, like him capable of being part of the problem as well as of the solution.

Owners with Skin in the Game — that, my friends, is the magic formula! And that is the challenge for the rest of us: How do we organize the trillions of dollars under management so as to emerge with activists capable of and willing to hold management to account? How can we corral Carl Icahn's energies to more holistic ends?

Let me begin to answer that with what is to me a foundational truth: Ownership needs to expand its agenda for the future. In the globalized world of commerce, effective and legitimate corporate functioning will require leadership from the business community and cooperation from governments. The future agenda must deal with at least the following issues:

A – Corporations must have a legal domicile importantly connected with its operations. "Domicile shopping" for the least effective governance regime must stop.

B –All constituencies need co-operate on developing a system of integrated accounting so that corporations stop having incentive to pursue societally destructive practices, and shareholders and customers stop being enablers of conduct that they personally deplore.

C – All publicly traded companies must have "real owners" – obviously, defining the requisite characteristics will require much flexibility as there is no shoe that fits every foot. What is critical is that there exist within the corporate framework an energy capable of acting as "steward" or even "fiduciary" for the stakeholders – capable of dealing with such issues as the permissible level of environmental impact and involvement in politics.

Let me leave you with two thoughts that hearken back to the World War with which I began this talk. Both thoughts would be hyperbolic were I not convinced that the social and economic fabrics of my country are at such risk. The first is a riff on the famous "First they came for …" formulation by the German theologian Martin Niemoller, who survived seven years in Nazi concentration camps: "First the CEOs paid themselves royally, and I said nothing because I wasn't a CEO. Then they ended pensions, captured government, corrupted international institutions, and suborned the judiciary. And finally they came for the owners … me."

Lastly, on a more upbeat note and to return to where I began, this abridgement from Winston Churchill's 1942 "End of the Beginning" speech, inspired by Rommel's defeat at El Alamein: "Henceforth, [those who oppose us]….will meet equally well armed, and perhaps better armed troops. Henceforth, they will have to face in many theatres … that superiority …. which they have so often used without mercy against others…."

The stakes are high. One reads today of daily attacks on government of, by, and for the people. Holding corporate power to account may well be the best, even the only opportunity to restore a civil society based on enduring human values, but the tide, I truly believe, is turning in our favor. Corporate hegemony is on notice. Management excesses will no longer go unchallenged. The fight that remains will be a long one, but I leave the struggle to all of you with great confidence.