The Government as Active Shareholder

B. Espen Eckbo*

Testimony
to
The Congressional Domestic Policy Subcommittee
of
The Oversight and Governance Reform Committee

December 16, 2009

*Professor B. Espen Eckbo holds the Tuck Centennial Chair in Finance at the Tuck School of Business, Dartmouth College, New Hampshire 03755 (USA). He also directs Tuck's Lindenauer Center for Corporate Governance, which he founded in 1999, and he is a Research Associate of the European Corporate Governance Institute. In 2005, he assisted Norway's Global Government Pension Fund, currently the world's largest institutional shareholder in global equity markets, in designing its corporate governance principles and strategy. Professor Eckbo's resume is available at www.tuck.dartmouth.edu/eckbo, and most of his research papers can be accessed at http://ssrn.com/author=98728. His testimony is given in his individual capacity as an academic expert in finance and corporate governance, and represents his own views alone.

Contents

The Government as Active Shareholder

by

Professor B. Espen Eckbo

Mr. Chairman and distinguished members of the Committee, thank you for inviting me to testify in today's hearing. My name is Bjorn Espen Eckbo. I hold the Tuck Centennial Chair in Finance at Dartmouth College's Tuck School of Business. I also direct Tuck's Lindenauer Center for Corporate Governance, which I founded ten years ago in 1999. I am testifying as an expert in financial economics and corporate governance.[1]

1 Introduction: The Value of Shareholder Activism

I have been asked to discuss principles for the government's exercise of its shareholder rights in companies like AlG, Citigroup, GM, and Chrysler, purchased under the Troubled Asset Relief Program (TARP) established by the Emergency Economic Stabilization Act of 2008 (EESA). The Obama Administration has begun to formulate principles for managing these shareholdings.[2] For example, the administration is committed to manage the ownership stake in a hands-off, commercial manner. The government will exercise its shareholder vote on core governance issues, such as director election and major corporate events or transactions. No government employee will serve on the boards or be employed by the companies. Moreover, consistent with Uncle Sam as a reluctant "owner of last resort", the shareholdings will be privatized at the earliest possible time, taking into account "conditions on the ground" in terms of the firm's financial health and aggregate capital market liquidity.

While these principles are sound, they lack detail and should be broadened. *I argue in this testimony that the government ought to adopt a pro-active stance in terms of exercising voting rights*. As I explain below, given the strong protection afforded minority shareholders under U.S. corporation laws, the emergence of a large blockholder is generally a positive development for the

[1]I am testifying in my individual capacity as an academic expert in finance and corporate governance. The views expressed herein are solely my own and should not be attributed to Dartmouth College or any other institution with which I am affiliated. I am grateful for the research assistance of Giulia Paone, a research associate of Tuck's Lindenauer Center for Corporate Governance. Karin Thorburn, Professor of Finance at the Norwegian School of Economics and Business Administration, made a major contribution to Section 2. I am also grateful for discussions with William Megginson, Rainbolt Chair in Finance at the Michael F. Price College of Business of the University of Oklahoma, on issues of state privatization programs.

[2]See, e.g., Mike Allen, "Obama Gives Rules for Owning Firms," *POLITICO*, June 1, 2009.

entire shareholder base. Minority shareholders benefit from the presence of a large blockholder because only the latter has the economic incentive to exercise voting rights in an efficient manner. Thus, the government is now in a unique position to improve inefficient governance practices. But this require taking a pro-active stance on share-voting in accordance with the value-maximizing principle and existing best governance practices. I provide some guidance along these lines below.

As shown in Exhibit 1, the institutional investor community, major stock exchanges, national governments, and international organizations such as the United Nations (UN) and the Organization for Economic Co-operation and Development (OECD), all have developed corporate governance recommendations. As the exhibit shows, governance standards emanate not only from statutes, but also from various investor organizations in the U.S. (e.g., the Council of Institutional Investors), major pension funds like TIAA-CFEF and CalPERS, and professional director organizations (e.g., the National Association of Corporate Directors).

Outside of the U.S., the International Corporate Governance Network (a global organization of large institutional investors), prominent national organizations such as the Canadian Coalition for Good Governance, and sovereign wealth funds like Norway's Government Pension Fund, are also actively developing standards and voicing demand for these to be adopted by their portfolio companies. Moreover, political and humanitarian organizations including the UN are widening the scope of the debate to also include "socially responsible investment" policies which add environmental and social objectives to the governance agenda.

These global governance standards evolve and are updated periodically. As a result, investor and public opinions around the world are converging both in terms of our conceptual understanding of the issues and recommendations for best practices. The political process has also picked up speed and is giving the governance reform movement momentum. To tap into this dynamic convergence process, I start with a basic tour of some key issues and their grounding in economic theory. Moreover, I provide broad strokes of the empirical evidence on the link between corporate governance end economic and financial development. The fact that countries with widely different legal traditions and level of economic and financial development tend to converge is a testimony to the power and reasonableness of the basic economic principles underlying the drive for governance reform.

In Section 2 of this testimony, I explain the basic logic of a corporate governance system, and how systems differ across Anglo-American and German legal traditions. This section, which helps provide a perspective on the recommendations in the subsequent sections, may be skipped by someone already familiar with the governance literature. Section 3 discusses issues concerning the practical management of the government's share-ownership, with a recent model example from the U.K.. This section also displays some of the specific concerns about state-ownership reflected in the governance guidelines issued by the Organization for Economic Co-operation and Development (OECD). Moreover, I comment on the difficult issue of determining a government exit (privatization) strategy. Section 4 discusses specific issues in the current U.S. governance debate. These include director election reform, splitting the roles of chief executive officer (CEO) and board chairmanship, removal of "draconian" takeover defenses, and last but not least, the shareholder "say on pay" movement. I summarize key recommendations at the end.

2 Corporate Governance Basics: Principles and Evidence

2.1 The shareholder value-maximization criterion

Organization of business activity involves contracting with factors of production for delivery of input factors such as labor, equipment, and capital. The set of contracts needed to establish this supply chain and bring the final product to market is an essential feature of what defines "the modern corporation". Corporate governance can be viewed as a set of principles and practices designed to manage and control potentially costly conflicts of interest which arise between the various contracting parties within this nexus of contracts.[3]

Viewing the firm as a nexus of contracts provides a practical decision rule for corporate directors in terms of balancing the diverse interests of the firm's contracting parties. Because the equity contract represents the most junior claim on the company's revenue flow (shareholders are the firm's "residual claimants"), it gets paid last. As in "a rising tide lifts all boats", the objective of maximizing shareholder value protects also more senior contracts with higher cash flow priority. Under most circumstances, what's good for common stockholders is also good for the firm's other constituencies.

[3] Michael C. Jensen and William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure," *Journal of Financial Economics* 3, 305-360 (1976).

There is one circumstance where shareholder interests are not aligned with creditors—and in which the value-maximization rule may become inefficient. When a company approaches bankruptcy, it may be in shareholders' interest to "go for broke" by switching to high-risk investment projects (effectively gambling with creditors money). If the gamble pays off, shareholders win, and if it fails, creditors loose. Bankruptcy laws around the world attempt to address this issue by retroactively transferring director fiduciary duties from shareholders to bondholders upon bankruptcy filing. For example, a dividend payment to shareholders in the months leading up to the bankruptcy filing may be reversed by the court. Moreover, corporate managers are themselves concerned with their long-term reputation as they need to find a new employer after bankruptcy, which further reduces risk shifting incentives in practice.[4]

It is my opinion that the legal system, in combination with personal managerial incentives, is sufficient to attenuate adverse risk-shifting incentives so that it is optimal for boards to maintain shareholder value maximization as the company's key objective for all practical purposes.

2.2 Minority shareholder protection

Because small shareholders find it too costly to closely monitor management, the separation of ownership and control in large modern corporation gives rise to an agency problem. This agency problem was recognized already by Adam Smith in 1776:

> "The directors of [joint stock] companies, however, being managers rather of other people's money than of their own, it cannot be well expected, that they should watch over it with the same anxious vigilance [as owners]. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company."[5]

The problem for small shareholders is that managers have access to sophisticated expropriation techniques. Corporate insiders around the world have been known to sell the firm's output or assets at below-market prices to another company in which they are beneficial owners (self-dealings), dilute shareholder rights through targeted security issues, receive excessive compensation, etc.[6]

[4]For empirical consistent with managerial conservatism prior to bankruptcy filing, see B. Espen Eckbo and Karin S. Thorburn, "Control Benefits and CEO Discipline in Automatic Bankruptcy Auctions," *Jopurnal of Financial Economics* 69, 227-258 (2003).

[5]Adam Smith, *The Wealth of Nations*, Cannan Edition (New York Modern Library) [1776] (1937) p. 700.

[6]See Andrei Shleifer and Robert Vishny, "A Survey of Corporate Governance," *Journal of Finance* 52, 737-783 (1997).

Moreover, small shareholders are generally more vulnerable to expropriation practices than are other stakeholders. The reason is that management continuously develops personal relationship with employees, customers, and suppliers. This is in contrast to outside investors, who remain useful to the company only at the few discrete points in time when the company needs outside capital.

For this reason, a corporate governance system is designed fundamentally to protect minority shareholder interests:

> *A corporate governance system is the set of constraints on minority shareholder expropriation implied by internal corporate control mechanisms, external capital market monitoring, and the country's laws and regulations.*

With this definition, the key question becomes whether the governance system is sufficiently sophisticated to allow small, outside investors to believe that corporate insiders will maximize firm value and return the profits to investors.

2.3 Mechanisms for investor rights protection

Countries with developed capital markets generally offer investor protection through an elaborate system of corporate-, bankruptcy-, securities-, and takeover laws. Key shareholder rights include the right to pro-rata dividends, to appoint the firm's board of directors, and to vote on major corporate investment decisions such as mergers. However, voting rights associated with equity ownership may be expensive to exercise.[7]

Small diversified stockholders quickly realize that attending shareholder meetings is not worth the effort (the so-called "free-rider" problem).[8] A consequence of diversified holdings is that few investor have the incentive to incur expenses in order to monitor and evaluate how the firm is run. Thus, if the firm does not have large investors in its ownership base, little shareholder monitoring

[7] For example, in some countries proxy voting is ruled out requiring shareholders to show in person to vote. See also Rafael La Porta, Florencio Lopez-des-Silanes, Andrei Shleifer and Robert Vishny, "Law and Finance," *Journal of Political Economy* 106, 1113-1131 (1998). For a detailed analysis of a country's share-voting system, see B. Espen Eckbo, Giulia Paone and Runa Urheim, "Efficiency of Share-Voting Systems: Report on Italy," Working Paper 2009-64, Tuck School of Business (2009).

[8] Classical finance theory hold that it is optimal for the typical investor to hold diversified portfolios of assets (Harry Markowitz, *Portfolio Selection*, New York: John Wiley & Sons (1959)). This is in fact a reasonable good description of individual investors in the U.S. and the U.K.. See Kenneth R. French, "The Costs of Active Investing," *Journal of Finance* 63, 1537-1573 (2008) for evidence on the low cost of holding passive diversified portfolios of stocks.

will take place.[9]

Because large owners have incentives to actively monitor management, concentrated ownership generally improves shareholder rights enforcement. However, the interest of large shareholders may sometimes conflict with the interests of minority stockholders. Therefore, the laws of most countries grant special legal protections to minority shareholders. For example, consider so-called "minority freeze-out" transactions, where a corporation's controlling shareholder bids for the remaining minority equity stake. These transactions frequently occur as a second-step or "clean-up" merger following a merger or tender offer. The judicial standard in the U.S. and most developed countries discourages coercive bids while encouraging full information arms-length negotiations between claimants.[10]

Creditor rights include the power to seize collateral, to uphold the seniority of loans, and to force a bankruptcy proceeding when the company fails to service its debts. Since default on a debt contract is a straightforward event that can be verified in court, legal protection of creditors is typically more effective than that of shareholders. Creditor rights are governed primarily by bankruptcy and insolvency law and vary with the degree of control rights allocated to shareholders and management in formal reorganization procedures.[11]

Outside investors depend on reliable information about the firm's performance to enforce their rights. Disclosure and accounting rules provide for accuracy and depth of the firm's financial statements. To verify the accuracy of the financial reporting, listed companies are required to have their financial statements certified by an independent accountant.[12]

The enforcement of regulation and laws is just as important as their content. A first-rate governance system requires laws and contracts to be strictly upheld by regulators and courts, as

[9] For a survey of ownership structures in the U.S., see Clifford G. Holderness, "A Survey of Blockholders and Corporate Control", *Federal Reserve Bank of New York Economic Policy Review* (2002).

[10] Given the potential for self-dealing, Delaware courts have maintained that freeze-out transactions are subject to judicial review, and grants appraisal rights to minority shareholders. See, e.g., Ronald J. Gilson and Jeffrey N. Gordon, "Controlling Controlling Shareholders," *University of Pennsylvania Law Review* 152, 785-843 (2003). For empirical evidence, see Thomas W. Bates, Michael L. Lemmon and James S. Linck, "Shareholder Wealth Effects and Bid Negotiation in Freeze-Out Deals: Are Minority Shareholders Left out in the Cold?", *Journal of Financial Economics* 81, 681-708 (2006).

[11] For surveys of creditor rights and bankruptcy law across countries, see e.g., Edith S. Hotchkiss, Kose John, Robert Mooradian, and Karin S. Thorburn, "Bankruptcy and the Resolution of Financial Distress", in B. Espen Eckbo, *Handbook of Corporate Finance: Empirical Corporate Finance*, Volume 2, (Elsevier/North-Holland Handbook of Finance Series), Ch. 14, 235-287 (2008), and B. Espen Eckbo and Karin S. Thorburn, "Bankruptcy as an Auction Process: Lessons from Sweden", *Journal of Applied Corporate Finance* 21, 36-50 (2009).

[12] In the U.S., the Securities Act of 1933, the Securities Exchange Act of 1934, and the Sarbanes-Oxley Act of 2002 require annual audits of the financial statements for firms issuing securities to the public.

well as by market participants. Thus, the legal and regulatory system complements the effectiveness of market forces in restricting expropriation by corporate insiders.

There are several important market forces that help reduce agency costs. For example, an active market for corporate control limits agency cost through the threat of managerial displacement in a hostile takeover. Also, a well-functioning managerial labor market disciplines top executives concerned with their future career opportunities. Moreover, firms requiring new outside capital must "dress up" for the capital market by presenting evidence of adequate internal control systems. There is a great variation across countries in terms of the effectiveness of these market forces.

The corporate board is the most important internal control system. Research indicates that the best boards are relatively small, have independent directors, require financial literacy, and rely on stock-based compensation of directors.[13]

Furthermore, an effective internal control system effectively aligns managerial and shareholder interests through stock-based executive compensation. Research also indicates that pay-for-performance schemes such as options and bonus plans alleviate agency costs and promote stock-market confidence. Compensation issues are discussed in greater details below.

3 Practical Management of the Government's Shareownership

3.1 Creating an independent management company

The form of the organization of the ownership management function is vital for the success of a policy of protecting the taxpayer. To minimize costly political jockeying for government favors—whether from inside the firm or from outside (local) constituencies—the management function should be organized so as to promote the view of the government as a strictly professional owner. This suggests that the management function should be organized in an independent entity with fiduciary duties to Congress (to satisfy statutory requirements for congressional control with TARP funds).

[13]For reviews of empirical studies on boards, see, e.g., Benjamin E. Hermalin and Michael S. Weisbach, "Boards of Directors As an Endogenously Determined Institution: A Survey of the Economic Literature," *Federal Reserve Bank of New York Economic Policy Review* 9, 7-26 (April 2003), Sanjai Bhagat and Brian Bolton, "Corporate Governance and Firm Performance," *Journal of Corporate Finance* 14, 264-269 (2008), Stuart L. Gillan, "Recent Developments in Corporate Governance: An Overview," *Journal of Corporate Finance* 12, 381 (2006), and Renee Adams, Benjamin E. Hermalin and Michael S. Weisbach, "The Role of Boards of Directors in Corporate Governance: A Conceptual Framework and Survey," National Bureau of Economic Research, Inc, NBER Working Papers: 14486, (2008).

This management entity should hold the government's shares in both the financial and automotive industries. The entity should ensure it has the expertise needed to adequately monitor and divest (privatize) these ownership positions. It would also be natural for the Treasury's exercise of corporate governance functions under TARP—including "say on pay" and the various other shareholder rights issues discussed below—to be located in this independent entity.

3.2 The case of U.K. Financial Investments Ltd.

After acquiring common stock through a government rescue program much like TARP in the U.S., the U.K. government in November of 2008 created a limited liability corporation, U.K. Financial Investments Ltd (UKFI, www.ukfi.gov.uk.), to manage its shareholdings. UKFI is a Companies Act Company (Company no: 6720891), with HM Treasury as its sole shareholder. The company's activities are governed by its Board, which is accountable to the Chancellor of the Exchequer and—through the Chancellor—to Parliament.

As of June 30, 2009, the government's shareholdings included 70 percent of the voting share capital in the Royal Bank of Scotland (RBS), and 43 percent of the voting shares in Lloyds TSB/Halifax Bank of Scotland (Lloyds Banking Group). The government also holds shares in Northern Rock and in Bradford & Bingley. The UKFI's management group consists of around 15 people. Membership of the UKFI Board comprises a private sector Chair, three non-executive private sector members, a Chief Executive and two senior Government officials. Sir David Cooksey is Chairman and John Kingman is Chief Executive.[14]

UKFI's Market Investments mission is to dispose of the Government's shareholdings in RBS and Lloyds in an orderly and active way, with due regard to financial stability and the promotion of competition. The fund anticipates that it eventually will be privatizing the holdings by selling shares to investors in the public equity markets. The prospect of this selling process means UKFI's main objective is to maximize the market value of the two banks.

UKFI formulates its management objectives as follows:[15]

- "We see ourselves as having five principal tasks:

[14] http://www.ukfi.gov.uk/about-us/
[15] http://www.ukfi.gov.uk/about-us/investments-strategy/

– understanding how the problems in the sector came about, learning the lessons and identifying the specific issues that our investee banks face;

– working with the boards and management at each bank to develop and implement an agenda to maximise value for shareholders;

– engaging with other investors and market participants to understand their views, and to seek to build confidence in our approach;

– developing and implementing a disposal strategy for the investments; and

– supporting Government (primarily HM Treasury) on their response to the crisis, from a shareholder perspective."

The UKFI objectives appear in a Framework Document (last revised on July 13, 2009) drawn up by both UKFI management and its shareholder, HM Treasury. In addition to the financial objectives above, the Framework Document states that:

- The government's ownership is temporary in nature.
- UKFI will elect qualified, independent non-executive members to the banks' boards.
- UKFI will engage actively with its portfolio companies in accordance with best institutional investor practice (using published information in a structured dialogue).[16]
- UKFI will ensure that there are no interlocking directorates between itself and portfolio companies or between portfolio companies with respect to its board representatives.
- UKFI will comply with the Code of Market Conduct, e.g., in situations where its management leads to the acquisition of inside (price-sensitive) information about its portfolio companies.
- UKFI will (on behalf of HM Treasury) vote all the shares in the Investee companies wherever practicable to do so, inform the relevant Investee Company in advance of its voting intentions, and disclose how it has voted.

[16]Section 3 of the Investment Mandate ("UKFI's approach to managing the Investments") establishes that: "In managing the investments, UKFI will (on behalf of HM Treasury) follow best institutional shareholder practice. This includes compliance with the Institutional Shareholders' Committee's Statement of Principles together with any developments to best institutional shareholder practice arising from recommendations or guidance contained in the Walker Review or elsewhere." The Institutional Shareholders' Committee's Statement of Principles, which set out best practices for institutional shareholders. published its Code on the Responsibilities of Institutional Investors on November 16, 2009, available at: http://institutionalshareholderscommittee.org.uk/sitebuildercontent/sitebuilderfiles/ISCCode161109.pdf.

Finally, the HM Treasury requires UKFI to seek prior approval from the Treasury on decision concerning "value-realization" transactions and "restructuring" transactions. In other words, the Treasury does not delegate to UKFI transactions which amount to a privatization of the fund, nor transactions which may require additional taxpayer capital infusion in order to restructure the Investee companies.

3.3 The case of Norway's $400+ billion sovereign wealth fund

Yet another interesting example of a country which decided to insulate the management of its financial assets from direct political control is Norway. While Norway (like Sweden) organizes its holdings of state-owned enterprises directly under the department of commerce, Norway's $400+ billion sovereign wealth fund is managed by a wholly-owned division of the Norwegian Central Bank (Norges Bank).[17] Formally, the Norwegian Treasury is the owner of the fund and sets broad guidelines for the fund's investment policy (and requires the fund to hold a broadly diversified portfolio held exclusively in foreign stocks and bonds). A major motivation for this structure is the desire to communicate to world capital markets that the fund operates like any other professional (non-political) investment company. The fund, which is the largest equity investor in the most liquid equity markets around the world today, represents the gold standard among sovereign wealth funds in terms of transparency and governance standards.

3.4 OECD guidelines for state-owned enterprises

OECD has issued a set of guidelines designed to help make state-owned enterprises (SOEs) become competitive, efficient and transparent.[18] These guidelines are fully compatible with the OECD Principles of Corporate Governance, but address issues more specific to the corporate governance of SOEs. While the governance of SOEs goes beyond the government's short-term shareholdings in TARP-rescued companies, the guidelines stress the state's responsibility for actively exercising its ownership functions and avoiding political interference in the management of the company.

To illustrate, the OECD guidelines for SOEs encourage the State to:

- Maintain a level-playing field for SOEs competing with the private sector by separating the

[17]The manager of the fund is Norges Bank Investment Management (NBIM).
[18]http://www.oecd.org/dataoecd/46/51/34803211.pdf.

state's ownership role from its regulatory role and other functions, and by making sure that SOEs' access to state financing is on competitive terms.

- Establish an active and transparent ownership policy, exercised through a separate ownership entity. This ownership entity should be held accountable to representative bodies such as the Parliament/Congress. Moreover, the SOEs should have full autonomy in its day-to-day operations.
- Exercise ownership rights in accordance with the SOE's charter and bylaws. The exercise of ownership rights requires being represented at the general shareholders meetings and voting the state's shares, establishing well structured and transparent board nomination processes in fully or majority owned SOEs, and participate in the nomination of boards.
- Set up reporting systems allowing regular monitoring and assessment of SOE performance.
- When permitted by the legal system and the state's level of ownership, maintain continuous dialogue with external auditors and specific state control organs.
- Ensure that remuneration schemes for SOE board members foster the long term interest of the company
- Recognize the rights of all shareholders and in accordance with the OECD Principles of Corporate Governance ensure their equitable treatment and equal access to corporate information. This requires SOEs to observe a high degree of transparency towards all shareholders and to develop an active policy of communication and consultation with all shareholders. The participation of minority shareholders in shareholder meetings should be facilitated in order to allow them to take part in fundamental corporate decisions such as board election.
- Require SEOs to report on their relations with all major stakeholders—not only shareholders.
- Empower boards by clarifying their mandates and respecting their independence; separating the role of Chairman and CEO and giving boards the power to appoint CEOs; create specialized committees to support the full board in performing its functions (particularly audit-, risk management-, and remuneration committees); and systematically monitor the board's performance.

- Improve transparency by strengthening internal controls; carry out independent external audits based on international standards; disclose any financial assistance from the state; and produce aggregate performance reports.

3.5 When and how to exit?

When and how can the U.S. government expect to be able to start privatizing its 79.9% ownership of AIG? For sure the company must be out of the woods—or the distressed debt overhang will make it impossible to sell equity. Until a realistic bottom has been reached in AIG's financial affairs, a sale is infeasible—no private buyer would purchase the company with open-ended need for continuing capital infusions. Also, it is unlikely that selling off AIG while it still has substantial outstanding government-guaranteed would be in the taxpayers' best interest.

Moreover, the optimal timing of the privatization depends on the aggregate supply of capital from institutions and households. Much as we observe for initial public offerings (IPOs) and Private Equity fund exits, state privatization sales tend to cluster in time, typically when the overall IPO and stock markets are historically high. Empirical research shows that the frequency of share issue privatizations (SIPs) were particularly high in 1998-2000 and, to a lesser degree, in 2003-07. The evidence of the past three decades of privatization experience also shows that the market for properly priced SIPs is highly elastic, with extremely large offerings being executed without much difficulty. This supports the view that, if global insurance market conditions are right, a sale of AIG can be structured successfully despite its large size.[19]

Following a decision to sell, international experience with privatizations further suggests that the state should strive to sell its ownership stake as quickly and transparently as feasible, for cash, and to the highest bidder, foreign or domestic. Governments have used three basic methods to privatize:

- Direct asset sale: sale of company or company assets in return for cash.
- A secondary sale of the state's shareownership to the public (SIP).

[19]For a comprehensive literature review of state privatization studies, see William L. Megginson and Jeffry M. Netter, "From State to Market: A Survey of Empirical Studies on Privatization," *Journal of Economic Literature* 39, 321-389 (2001). For evidence on "hot" issue markets, see the survey by B. Espen Eckbo, Ronald W. Masulis and Oyvind Norli, "Security Issues," in B. Espen Eckbo (ed.), *Handbook of Corporate Finance: Empirical Corporate Finance* Volume 1(Elsevier/North-Holland Handbook of Finance Series), Ch. 6, 233-373 (2007).

- Voucher privatization: vouchers exchangeable into the state's common stock are distributed to citizens for free.

Internationally, the SIP method is more likely to be used (1) the larger the firm, (2) the stronger are a country's investor rights protection, and (3) the more profitable the firm being privatized.[20]

If AIG is too big to be sold to a competitor when it reaches core profitability, then the only real option would be a secondary offering to the market or to a private equity investors.[21] A targeted auction to private equity investors could be arranged quickly and would likely fetch a higher price per share sold than would a SIP, but a seasoned public offering would be more transparent and therefore more politically acceptable. Depending on the total market value of AIG at the time of the offering, the sale could be structured as a single block or split into several tranches.

4 Strategies for Government Shareholder Activism

As discussed in Section 2 above, any corporate governance system relies on shareholders exercising voting rights. By substantially concentrating the share-ownership of the TARP recipients, the government has already helped resolve a structural governance problem that plagued these and most other widely held companies for years: the tendency for small shareholders not to exercise their vote—or to passively cast their votes in favor of management. Firms pay up front for market concerns with wealth expropriation through a higher cost of equity and debt capital, which in turn stifles economic activity. It is therefore important that the unit created to hold and manage the government's equity ownership in TARP recipients actively (through voting) supports core corporate governance principles. I discuss four important areas of governance reform next.

[20] See William L. Megginson, Robert C. Nash, Jeffry M. Netter and Annette Poulsen, "The Choice of Private Versus Public Capital Markets: Evidence from Privatizations," *Journal of Finance* 59, 2835-2870 (2004). Other countries have far greater experience with privatizations than the U.S.. The only two major share issue privatizations (SIPs) executed by the U.S. Federal government over the past quarter-century are Conrail in 1987 and U.S. Enrichment Corp in 1999.

[21] The limited experience with voucher programs around the world suggests that vouchers is an inferior privatization method to both SIPs and direct asset sales.

4.1 Director election reform

The SEC has recently issued a proposal to reform the director nomination and election procedure for U.S. public companies.[22] The proposal changes the federal proxy rules so as to remove certain impediments to the exercise of shareholder rights to nominate and elect directors to company boards. The new rules would require, under certain circumstances, a company to include in the company's proxy materials a shareholder's, or group of shareholders', nominees for director. In addition, the new rules would require companies to include in their proxy materials, under certain circumstances, shareholder proposals that would amend, or that request an amendment to, a company's governing documents regarding nomination procedures or disclosures related to shareholder nominations.

This proposal has far-reaching implications for the director election process. Under the existing system, shareholders receive a ballot listing the directors nominated by the company only. Suppose the election is uncontested, i.e., no shareholder has launched a proxy contest for directors.[23] There are now two scenarios: the company allows shareholders to elect directors either with a "plurality" or with a "majority" of the votes cast. Companies with plurality voting mails out a proxy card asking shareholder to tick off one of two boxes: "yes" or "abstain". In principle, under this plurality system, you need only a single "yes" vote in order to formally have been elected. While a low yes count is, of course, an embarrassment to the nominated directors, there are no formal constraints on the number of yes votes required to be elected. More importantly, there is no mechanism (other than an expensive proxy contest) for shareholders to register objections to the nomination. Shareholders who "abstain" do so either because they object or because they simply do not care, and it is not possible to tell which of the two sentiments best describes the voting outcome.[24]

The second scenario is for companies who have passed majority voting. Now the company mails out a ballot with three boxes, "yes" "no" and "abstain". The director nominee is elected if the number of yes votes exceeds the number of no votes, while votes to abstain do not affect the election

[22] SEC Proposed Rule "Facilitating Shareholder Director Nominations", File No. S7-10-09 (June 10, 2009). http://sec.gov/rules/proposed/2009/33-9046fr.pdf.

[23] In a proxy contest, a dissenting shareholder goes through a costly proxy registration procedure and shareholder solicitation process.

[24] Under a "plurality-plus" standard, directors are elected by plurality voting but must offer to resign if the holders of a majority of shares withhold their votes.

outcome.[25] In this case, there is a clearer message to the director nominee concerning the actual support received. However, the degree of support is still an open question because a large number of shareholders may have chosen to abstain rather than vote no when they are given only a single slate of director nominees to vote for. Absent an alternative, the best choice may simply be to let the company's proposal pass. For example, shareholders who are generally critical of the a board's executive compensation policy may be reluctant to fire the board in the absence of an alternative.[26]

The SEC proposal further improves upon the majority rule and extends the improved proxy voting system to all public companies. The proposal is to allow, under certain conditions, shareholders to include their own director nominee in the company's proxy material and on the ballot. Since voting in favor of the shareholder nominee is effectively a "no" to the company's nominee, this effectively eliminate the pure plurality voting system in favor of majority voting. Furthermore, since shareholders now have two competing candidates for director, the proposed system also improves on the majority voting system.[27] The current U.S. director election system weakens the U.S. corporate governance system. The time for reform has come.

[25] Citigroup Inc. has adopted a By-law providing a majority vote standard for director elections. Under Article 4 ("Directors", Section 1) of the Citigroup Bylaws, "A nominee in an uncontested election shall be elected to the Board of Directors if the votes cast for such nominee's election exceed the votes cast against such nominee's election. For purposes of these By-Laws, an "uncontested election" means any meeting of stockholders at which directors are elected and with respect to which either (i) no stockholder has submitted notice of an intent to nominate a candidate for election pursuant to Section 11 of article III of these By-Laws or (ii) if such notice has been submitted, all such nominees have been withdrawn by stockholders on or before the tenth day before the company first mails its notice of meeting for such meeting to the stockholders. In all director elections other than uncontested elections, directors shall be elected by a plurality of the votes cast, and stockholders shall not be permitted to vote against any nominee for director. (...) If a nominee in an uncontested election is not elected by a majority vote, then the Director shall offer to resign from his or her position as a Director. Unless the Board decides to reject the offer or to postpone the effective date of the offer, the resignation shall become effective 60 days after the date of the election. In making a determination whether to reject the offer or postpone the effective date, the board of Directors shall consider all factors it deems relevant to the best interests of the Company. If the Board rejects the resignation or postpones its effective date, it shall issue a public statement that discloses the reason for its election. (...)" (http://www.citigroup.com/citi/corporategovernance/docs.htm).

[26] Note also that the most common models of majority voting merely require that nominees not receiving a majority of votes submit a letter of resignation. Boards may reject the letter and, in fact, have done so on a number of occasions, effectively overturning the decision of shareholders. See, e.g., J. Robert Brown, "Majority Voting, Delaware Statutory Reform, and Shareholder Access to the Proxy Statement: A Comment to the Securities and Exchange Commission," U Denver Legal Studies Research Paper No. 09-24 (2009).

[27] Under the SEC proposal, to have access to the company's proxy material and the ballot, a shareholder or group of unaffiliated shareholders must own a minimum fraction of the shares: 1% if the company has net assets of $700 million or more; 3% for companies with assets between $75 million and $700 million; and 5% if the firm has assets less than $75 million. Moreover, the shares must have been held for at least one year prior to the date the shareholders notifies the company of its intent to nominate a director. Unaffiliated shareholders are permitted to aggregate their holdings for the purpose of meeting this minimum shareownership requirement. The right is to nominate at most one director for a board of seven or less, or up to 25% of the directors for larger boards. To replace a greater number of directors, shareholders must engage in the traditional proxy contest. The right to nominate is on a first-come-first-serve basis.

4.2 Eliminating costly takeover defenses

As discussed above, since the vast majority of shareholders diversify their holdings across firms (in order to reduce their exposure to firm-specific risk), large corporations often end up with a widely dispersed shareholder clientele. In this situation, the costs of monitoring incumbent managers will exceed the benefits for each (small) investor, and the majority of the firm's shareholders will remain passive owners of the corporation. Implicitly, these shareholders must rely on market forces, such as competition among managers in the market for corporate control, to align the interests of managers and owners.[28] For this reason, takeover defenses which curb takeover activity risks reducing the overall efficiency of the corporate sector.

It is common in the governance literature to distinguish between external and internal markets for corporate control. The external control market involves takeover bids and specific target responses while the internal market involves general board actions and shareholder voting. Examples of internal antitakeover provisions are classified (staggered) board (directors are divided into separate classes—typically three—and elected to overlapping terms), unequal voting rights (e.g., two classes of common, one with zero voting rights), and various restrictions on shareholder rights to amend company charter and bylaws, to act by written consent, and to call special meetings. Examples of external antitakeover provisions are poison pill or shareholder rights plan, supermajority requirements to approve a merger, blank check preferred stock (used to implement a posion pill), and fair price provision (requires a large shareholder to pay a minimum price set by formula for all shares acquired in the back end of a two-tiered acquisition).

When adopting the poison pill, the corporation issues to its stockholders (usually by means of a dividend) certain rights to purchase stock (typically preferred). The rights are out of the money

[28] "The managerial competition model...views competing management teams as the primary activist entities, with stockholders (including institutions) playing a relatively passive, but fundamentally important judicial role. Arbitrageurs and takeover specialists facilitate these [corporate control] transactions by acting as intermediaries to value offers by competing management teams, including incumbent managers. Therefore, stockholders in this system have relatively little use for detailed knowledge about the firm or the plans of competing management teams beyond that normally used for the market's price setting function. Stockholders have no loyalty to incumbent managers; they simply choose the highest dollar value offer from those presented to them in a well-functioning market for corporate control, including sale at the market price to anonymous arbitrageurs and takeover specialists. In this perspective, competition among managerial teams for the rights to manage resources limits divergence from shareholder wealth maximization by managers and provides the mechanism through which economies of scale or other synergies from combining or reorganizing control and management of corporate resources are realized." Michael C. Jensen and Richard R. Ruback, "The Market for Corporate Control: The Scientific Evidence," *Journal of Financial Economics* 11, 5-50 (1983).

(the exercise price exceeds the then market price) and not exercisable until a triggering event. The triggering event is that someone acquires a certain percentage (e.g., 15%) of the firm's voting shares. Pending their exercise, the rights may be redeemed for a nominal value by the board. If triggered, the rights give each holder, other than the stockholder that triggered the pill, the right to purchase shares of the issuing corporation (flip-in) or of the acquirer (flip-over) at a deep discount (e.g., 50%) to the market price. Pills may be issued by the board without prior stockholder approval, and they may be issued after having received a hostile bid ("morning after" pill).[29]

In 1985, the Delaware Supreme Court upheld Household International's adoption of a shareholder rights plan as reasonable under the Unocal standard, even though the company did not face a hostile threat.[30] Subsequently, Delaware has upheld the right of a board to refuse to redeem a pill in the face of an all-cash, non-coercive tender offer, even though a majority of the company's stockholders had tendered their shares to the bidder.[31] On the other hand, Delaware courts have invalidated the so-called "dead-hand" poison pill, which attempted to provide that only "incumbent" directors could redeem the rights, thus preventing directors elected by the hostile bidder from unwinding the pill.[32] This is an important decision as one (although costly) way to circumvent the pill is to launch a proxy contest simultaneously with the hostile offer, in the hope of winning enough board seats to have the board rescind the pill and let the offer go through.

The combination of a hostile bid and a proxy contest does not work if the target board is classified or staggered. For example, if only one-third of the board is up for election, the hostile bidder cannot win the majority needed to rescind the pill. Thus, by eliminating staggered boards, one also limits the scope for the poison pill to act as a costly antitakover defense of inefficient incumbent target managements.

4.3 Splitting the CEO and Chairmanship positions

The international governance standard and practice is to separate the positions of CEO and Chairman of the board (in some cases, like Sweden, by statute). It is my recommendation that U.S.

[29] Pill adoptions does not require a shareholder vote since it is akin to a dividend payment. Recently, there is a growing demand from large institutional shareholders such as pension funds to allow shareholders to vote on pill adoptions.

[30] Moran v. Household International, Inc. 500 A.2d 1346 (Del. 1985).

[31] Moore Corp., Ltd. v. Wallace Computer Services, Inc., 907 F. Supp. 1545 (D. Del. 1995).

[32] Quickturn Design Systems, Inc. v. Shapiro 721 A.2d 1281 (Del. 1998). This version of the pill had been upheld under Georgia Law, but also invalidated under New York law.

companies adopts this model as well.

The typical defence of having insiders on boards is one of efficiency: the board requires CEO and other management input to make proper decisions. What is not explained by this argument, however, is why the CEO needs a vote on the board—let alone the *chairmanship*—in order to supply the board with his or her input. Boards may—and regularly do—delegate the compensation decision to a board compensation committee consisting of independent directors only. Nevertheless, it takes a strong-willed character to resist the will of the CEO-chairman, even for directors that meet technical criteria for independence. In todays system, the vast majority of directors sit on boards because the CEO recommended their appointment (and the director election system made it difficult to defeat incumbents), so a certain loyalty can be expected.

It has also been argued that, because of the difficulty of writing employment contracts which cover all possible future contingencies, it may sometimes be efficient to complement imperfect employment contracts with board seats. Presumably, the board seats allow employees to influence the firm's investment strategy and thus effectively control some of the adverse contingencies which the employment contract leaves out. I do not, however, favor using the board chairmanship as a way to improve on CEO employment contracts in this sense.

Given that a major task of the board is to hire and fire the CEO and set his or her compensation, it makes intuitive sense that the CEO should not also occupy the chair position. Moreover, the system with an independent "lead director" running the board in situations where the CEO is conflicted seems inefficient: why have two "bosses" on the board when one is enough? Why not just make the lead director the chair? On this issue, I believe the international standard has got it right and the U.S. wrong: CEOs may sit on the board but not as chair.

4.4 Shareholder "Say on Pay"

There is broad agreement that executive pay should be structured so as to depend on firm performance. One way to obtain such "pay-performance sensitivity" is to grant the executive stock-based compensation (stock options or restricted stock grants). As long as the executive is in a position to affect the firm's stock price through his or her work effort, stock-based compensation means that the more effective the executive the higher the stock price and the greater the executive's reward.[33]

There is also broad consensus that executive compensation packages in the late 1980s exhibited too low pay-performance sensitivity.[34] This view, combined with the 1993 Omnibus Budget Reconciliation Act which defined non-performance (cash) related compensation in excess of $1 million as unreasonable and therefore not deductible as an ordinary business expense for corporate income tax purposes, led boards to adopt greater use of stock-based (and tax deductible) compensation instruments. By the end of the 1990s, the typical CEO of a large U.S. corporation received approximately 60% of the total pay in the form of stock options and/or stock grants. The total CEO compensation among the Standard & Poor 500 companies averaged in excess of $10 million at the end of the decade, a historically high average. The "say on pay" movement, which began to gain political momentum in the U.S. in the early 1990s, was also fueled by reports of extreme pay packages in excess of $100 million in companies like Global Crossing, Qwest Communications, Tyco International, Citigroup, Hewlett-Packard, and others.

As of today, a number of legislative initiatives in addition to EESA and ARRA have say on pay provisions. For example, on March 19, 2009, the House of Representatives passed without amendments and sent the Senate a Bill "To impose an additional tax on bonuses received from certain TARP recipients". The Bill, introduced by Rep. Charles Rangel, has been placed on the Senate Legislative Calendar. In May of 2009, Senators Schumer (D-NY) and Cantwell (D-WA) introduced the Shareholder Bill of Rights Act of 2009 (S. 1074). On July 1, 2009, the SEC published Proposed Rule: "Shareholder Approval of Executive Compensation of TARP Recipients" pursuant to EESA's section 111(e) as amended by ARRA, which requires TARP recipients to provide a nonbinding shareholder vote on the compensation of the executives whose compensation is required to be disclosed under SEC disclosure rules. On August 1, 2009, the House of Representatives passes a Bill (H.R.3269 - Corporate and Financial Institution Compensation Fairness Act of 2009) to curb executive pay (presented by Democrat Frank Barney). On November 10, 2009, Sen. Christopher Dodd, chairman of the Senate Committee on Banking, Housing and Urban Affairs, circulated a discussion draft proposing legislation aimed at reforming the financial sector (the "Restoring

[33]For a recent survey of the literature on executive compensation, see Rajesh K. Aggarwal, "Executive Compensation and Incentives," in B. Espen Eckbo (ed.), *Handbook of Corporate Finance: Empirical Corporate Finance*, Volume 2 (Elsevier/North-Holland Handbook of Finance Series), Ch. 17, 498-538 (2008).

[34]See Michael C. Jensen and Kevin J. Murphy, "Performance-Pay and Top Management Incentives," *Journal of Political Economy* 98, 225-264 (1990).

American Financial Stability Act of 2009").

The paradox of the say on pay movement is that, although there is little doubt that some pay packages are excessive, it is doubtful that shareholders are in a position to improve the compensation system. If the theory is that boards get it wrong, it is unclear why one should believe that shareholders will get it right. From the point of view of economic theory, the market wage of a CEO reflects the CEO's marginal productivity (value added) in the company. While it is possible to get a reasonable estimate of the value-added of Michael Jordan joining the Chicago Bulls (which may be why no-one seems to argue that sport superstars like Jordan and others are overpaid), identifying the marginal productivity of a CEO who works in a large organization is much more difficult. Awarding millions of dollars in executive pay—without being able to forcefully communicate to investors why the CEO is supposed to be worth as much—guarantees a demand for "say".

It should be obvious that one cannot design CEO pay structures by a shareholder vote. The main value of the say on pay movement is not in its contribution to setting pay, but in forcing boards to work harder at researching, negotiating, and communicating its pay policies to shareholders. As indicated above, shareholder mistrust of the board is also a direct result of inefficiencies in the director election mechanism. Thus, a benefit of reforming the director election system is to lower demand for shareholder say on pay as a way to force boards into acting in shareholder interests.

5 Summary recommendations

The government as a shareholder ought to:

(1) play a proactive role in developing best corporate governance practices (Section 1),

(2) support a policy of maximizing shareholder value (Section 2.1),

(3) promote transparency and a focus on minority shareholder rights protection (Section 2.2),

(4) organize the management of its ownership positions in an independent entity (Section 3.1),

(5) support director election reform (Section 4.1),

(6) support the elimination of staggered boards (Section (4.2),

(7) support a separation of the positions of CEO and board Chairmanship (Section 4.3),

(8) support compensation policies that based on sophisticated empirical analysis of CEO value added (Section 4.4).

EXHIBIT 1

Corporate Governance Statutory and Best Practice Framework for TARP Recipients

Overall Corporate Governance Framework

State and Federal laws, Stock Exchange listing rules, corporate governance standards

US Corporate Governance Statutory Framework

Delaware General Corporation Law (as amended)

Federal securities law:

- *Securities Act of 1933 (as amended)*
- *Securities Exchange Act of 1934 (as amended)*
- *Sarbanes–Oxley Act of 2002*

Emergency Economic Stabilization Act of 2008 (EESA)

American Recovery and Reinvestment Act of 2009 (ARRA)

- TARP Standards for Compensation and Corporate Governance

Stick Exchange Listing Rules

- *NYSE Corporate Governance Listing Standards (Section 303A)*
- *NASDAQ Corporate Governance Requirements (Rule 5600 Series)*

Examples of Corporate Governance Standards in the US

Council of Institutional Investors (CII), *Corporate Governance Policies (2009)*

Teachers Insurance and Annuity Association - College Retirement Equities Fund (TIAA-CREF), *Policy Statement on Corporate Governance (2004)*

California Public Employees' Retirement System (CalPERS), *Global Principles of Accountable Corporate Governance (2009)*

National Association of Corporate Directors (NACD), *Key Agreed Principles to Strengthen Corporate Governance for U.S. Publicly Traded Companies (2009)*

Examples of Global Corporate Governance Standards

Organization for Economic Co-operation and Development (OECD):

- *Principles of Corporate Governance (2004);*
- *Guidelines for Multinational Enterprises (June 2000);*
- *Guidelines on Corporate Governance of State-owned Enterprises (2005)*

United Nations (UN) Global Compact's Ten Principle

Unite Nations (UN) Principles for Responsible Investment (PRI)

International Corporate Governance Network (ICGN):

- *Statement on Global Corporate Governance Principles (2005);*
- *Statement of Principles on Institutional Shareholder Responsibilities (2007)*
- *Remuneration Guidelines (2006);*

Canadian Coalition for Good Governance (CCGG):

- *Corporate Governance Guidelines for Building High Performance Boards (2005)*