The Emergence of Fiduciary Capitalism

James P. Hawley and Andrew T. Williams

The twentieth century has seen a sea change in the concentration of ownership of U.S. corporations. Early in the century Berle and Means identified the divorce of ownership from control as the central corporate governance problem, but since the 1970's ownership has been re-concentrating into the hands of fiduciary institutions – most notably pension funds and mutual funds. By the 1990s fiduciaries collectively owned over 50% of the outstanding equity of the 1,000 largest corporations. This new pattern of ownership, fiduciary capitalism, has begun to raise important policy questions including: How can agents (fiduciaries) effectively monitor other agents (boards of directors)? What are the social implications of universal ownership where fiduciaries own substantial stakes in virtually all of the corporations in a country, and, finally, What does it mean to maximize shareholder wealth when fiduciaries are universal owners?

Key words: fiduciary capitalism, corporate governance, universal ownership, institutional investor activism, monitoring.

Introduction

The history of equity ownership in the United States in the twentieth century is one of dispersal followed by concentration. Early in the century, Berle and Means (1932) observed that the dispersion of equity ownership had led to a transfer of effective control from individual owners to professional managers. By the end of World War II, at the latest, ‘managerial’ capitalism had come to replaced entrepreneurial capitalism (1977). Then starting a bit after mid-century corporate ownership began to re-concentrate. This time, not into the hands of individuals, but into the hands of financial institutions, notably public and private pension funds and mutual funds.

By 1994 re-concentration had proceeded to the point where these three classes of institutions collectively owned 57% of the outstanding equity of the 1000 largest US corporations (Brancauto 1995). As Table 1 shows, in recent years equity ownership by institutions accounts for about 50% of the equity of all publicly traded companies. While any one institution typically owned only a relatively small portion of a corporation’s equity, some institutions – particularly the public employee retirement systems in the largest states, TIAA-CREF, the pension fund for college teachers, and mutual funds – came to hold substantial blocks of stock both individually and, certainly, taken as a group.

We believe this current stage of American capitalism might well be characterized as ‘fiduciary capitalism’ since these institutions own equity on behalf of others (retirees, future retirees, or individuals who have purchased shares in mutual funds). In fulfilling their role, institutions are legally required to act as a ‘fiduciary.’ That is, they are legally required to take only those actions a ‘prudent person’ would take to further the best interests of the beneficiary. This, coupled with the fact these institutions have very long term liabilities and, therefore, long time horizons, has extremely important implications for corporate governance, and for the economy as a whole.
Table 1. Relative growth in market value, all domestic corporations vs. top 1000: 1990–1994

<table>
<thead>
<tr>
<th></th>
<th>1990 ($ billions)</th>
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<tbody>
<tr>
<td>Market Value of All</td>
<td></td>
<td></td>
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<td></td>
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<tr>
<td>Domestic Corporations</td>
<td>3,312.1</td>
<td>4,570.2</td>
<td>5,144.6</td>
<td>5,724.9</td>
<td>5,553.1</td>
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<tr>
<td>Market Value of Top 1000</td>
<td></td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Corporations</td>
<td>2,950.0</td>
<td>3,375.0</td>
<td>3,842.0</td>
<td>4,149.0</td>
<td>4,338.0</td>
</tr>
<tr>
<td>Market Value of Top 1000 as a Percentage of Market Value of All Domestic Corporations</td>
<td>89.1%</td>
<td>73.8%</td>
<td>74.7%</td>
<td>72.5%</td>
<td>78.2%</td>
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<tr>
<td>Percentage of Top 1000 Corporations Held by Institutional Investors</td>
<td>49.5%</td>
<td>51.0%</td>
<td>53.0%</td>
<td>55.8%</td>
<td>57.1%</td>
</tr>
<tr>
<td>Percentage of All Domestic Corporations Held by Institutional Investors</td>
<td>50.7%</td>
<td>47.4%</td>
<td>47.3%</td>
<td>49.5%</td>
<td>51.5% (3Q)</td>
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Fiduciary duty legally requires institutions to act vigorously to promote — and only promote — their beneficiary’s interests. The prudent person rule also encourages institutions to act conservatively since actions deemed imprudent can result in personal liability to the fiduciary. The safest course is to take only those actions generally accepted as prudent — which historically has led institutions to adopt a conservative view of their responsibilities as owners. This conservatism is well illustrated by the indexing of portfolios, a practice of a great many institutions under which investments are chosen to mirror a market index such as the Standard and Poor’s 500 index. With an indexing strategy, trading is passively driven by the need to conform ownership to the index, not by a desire to hold any particular stock.

One might expect that the re-concentration of ownership in the hands of institutional owners coupled with fiduciary rules and an indexed portfolio would complete the divorce of ownership from control. In fact, to a large extent, the opposite has happened. The requirement to act in the beneficiary’s best interest has been increasingly interpreted to require that institutions vote proxies and oppose management policies (poison pills, for example) that reduce shareholder wealth. Some institutions such as the California Public Employee Retirement System (CalPERS) have noted that the only way they can discharge their fiduciary duty when maintaining an indexed portfolio is to actively attempt to improve the performance of individual companies (Koppes and Reilly 1995). This has led institutions to actively promote corporate governance reforms which strengthen their ability to act as owners.

The financial approach to corporate governance

The appropriate role of the corporation in American society is the subject of a large and active debate. There are several contending views on this subject, but it seems fairly clear that as far as fiduciary institutions are concerned the matter is settled. From a fiduciary’s perspective the finance approach in which the only goal of the corporation is to maximize long term shareholder wealth

The only goal of the corporation to maximize long term wealth
The link between corporate governance and corporate performance

Central to the finance view of the modern corporation is the proposition that governance – the rules and institutions by which agents are constrained to act – matters to corporate performance. Good governance should equate to the maximization of long term shareholder wealth. Better governance should be an improvement on poor governance. However, a survey of the available empirical studies shows one pause since most studies fail to establish a link between good governance and good performance. Typical of these studies is the conclusion of Karpoff et al. who after studying 866 shareholder initiated proxy proposals concluded that: “Even the most successful proposals do not significantly alter their target firm’s policies or stock values.” (1995 1)

While this result is generally borne out in other studies, some authors do find a link between performance and certain governance features. Chief among these is a study by Gordon and Pound (1991) in which they found corporations with fewer antitakeover governance measures in place out performed corporations with more antitakeover measures in place. This leads to the presumption that removal of antitakeover measures should enhance performance, but that is just the evidence Karpoff et al. failed to find.

While evidence of a general link between specific shareholder initiatives and corporate performance is yet to be clearly sustained, there is a growing body of evidence that certain kinds of institutional ‘pressure’ on underperforming companies can make a difference to corporate performance. This pressure often comes in the form of a proxy proposal or a request for a change in corporate governance (splitting the CEO and the chair is a popular vehicle) – but everyone involved understands that performance not governance is the real concern.

A number of institutional investors such as CalPERS and associations such as the Council of Institutional Investors (CII), have undertaken to systematically target underperforming companies with the explicit goal of improving shareholder value (Hawley and Williams 1994). Studies by Strickland et al. (forthcoming), Opler and Sokobin (1995), Wahal (1995), and most importantly Nesbitt (1994), find excess returns at firms that have been targeted as part of these larger programs which are primarily informal and ad hoc and, until 1992, conducted almost entirely by press
release. What may be happening here is that management is responding to general pressure from activist investors by redoubling their efforts to satisfy these shareholders’ desire for performance.

The governance implications are that specific institutional changes in the board of directors may not be as important as general rule changes that enable institutions to bring effective pressure to bear on underperforming companies. Such measures may allow, for example, institutions to caucus with one another, to coordinate their approach to a particular underperforming company, and to communicate directly with management in ways that don’t invoke expensive, restrictive proxy mechanisms and which may potentially expose institutions to large liabilities. An example of such reforms would be the 1992 relaxation of the SEC rules on communication (see Pound 1993).

Monitoring and corporate governance in the United States

Given that direct actions such as proxy filings have not been shown to be generally effective, institutional owners have had to redirect the focus of their corporate governance activities. Increasingly what they have done is to ‘monitor’ underperforming firms in their portfolios. “Monitoring” describes the informal and formal ways institutions seek to influence the performance of corporations. Monitoring may range from ad hoc and informal responses to a crisis such as the role institutions played at IBM, GM, and other companies in 1992 and 1993 to the ‘just vote no’ campaigns advocated by Grundfest (1993) to the targeting programs of CalPERS and CII to structured, long term relationships characterized by the term ‘relationship investing’ and as practiced by Warren Buffett.

What all of these forms of monitoring have in common is that they have arisen because institutions have found their ability to exercise their right to exit – to sell their position severely limited. The limitation comes from their size – sales move markets – and from fiduciary behavior that has encouraged them to use indexing as an investment strategy. If institutions can’t sell, they have to care. And to care is to monitor.

Consequently, a great deal of recent thinking on corporate governance in the United States has focused on developing ways to strengthen the voice of institutional investors. Much of this has centered on traditional board reform issues – independent nominating committees, splitting the CEO from the chair, etc. – but, increasingly, the focus has also been on general ways to increase shareholder voice. Thus, reforms which allow investors to communicate without fear of setting off onerous proxy reporting requirements are measures that strengthen shareholder voice by contributing to coordination of targets and coalition building around approaches. The goal of these policy initiatives is not to enact specific changes in the bylaws. Rather it is to make changes in rules, regulations, and practices that enable shareholders to ‘energize’ the board of directors and to support individual directors in playing their traditional role as representatives of the owners. The overall goals are the same as those of the traditional finance model discussed above – wealth maximization – but the approach to the problem is much broader than simply constructing a set of explicit contracts to solve a given principal-agent problem.

In addition to casting the principal-agent problem in a broader context, many commentators cast corporate governance in general and monitoring in particular in a wider political context. Grundfest (1990) notes that agency problems aren’t just inefficiencies to be corrected, but entitlements to be allocated by a political process. Likewise, Roe (1994) details the many restrictions placed on the exercise of ownership from the Glass-Steagall Act to the Federal Employee Retirement Security Act (FERSA).

The conclusion is that monitoring by institutional investors is an inherently political process in which the ‘rules of the game’ are determined by state legislatures, Congress, and the regulations of key federal agencies such as the Department of Labor, the Department of Justice, and the Securities and Exchange Commission. In this context, important policy issues in corporate governance are likely to be external to the boardroom and are likely to deal with the rights and restrictions placed on owners (institutions) in their attempts to influence the economic performance of corporations.

Corporate governance reforms

There is currently underway a long-term paradigm shift in both corporate law and in government policy – a shift reflecting the sea change in ownership already well developed. These policy currents – which have lagged considerably behind the fundamental events that are driving them – have led to a reconsideration of the role of regulation originally adopted in the 1930s to protect small individual investors from domination...
and manipulation by large individual investors such as J. P. Morgan. It has also led to rethinking certain assumptions embodied in the Employees' Retirement Income Security Act of 1974, commonly referred to as ERISA. The re-concentration of ownership, primarily in fiduciary institutions, led to calls for both more and less regulation. So far, only a few of these proposals have become policy. Most important among these have been the 1992 communication rule liberalization by the SEC, and the 1988 and 1994 Department of Labor’s interpretation of the ‘Avon Letters’ expanding the understanding of fiduciary duty to include monitoring.

A discussion of governmental policy proposals can be divided into two categories, those primarily concerned with voice and those primarily concerned with exit. 3 Significant among those which would deregulate voice are the various communication liberalization proposals which redefine ‘control’ of a firm in order to shield institutions from liability and a proposal to promote ‘relational funds’ by making less restrictive certain aspects of the 1940 Investment Company Act. In addition to proposals to deregulate voice, others would positively regulate an encouragement to exercise voice by providing incentives to monitor as well as by mandating a duty to monitor. Since part of effective monitoring involves greater access to information and greater transparency of board of director actions, some reforms call for additional regulations in these areas.

In addition to reforms restructuring voice, proposals have been made to restructure exit. The goal of many of these proposals is to simultaneously encourage or maintain efficient markets and to provide incentives to institutions to hold equity for the long-term. Particular proposals focus on insider trading laws and regulations which are seen to inhibit monitoring. Although their explicit purpose is to prevent ‘unfair’ gains by trading short-term on insider information, they may, in fact, deny long term holders access to crucial information necessary to monitor effectively.

While governmental policy actions and proposals are a critical area, policy developments and activities among institutional investors and corporations — within the current constraints of law and regulations — are also important. Proposals in this area can be divided into those that focus on policies internal to the corporation and those that are internal to financial investors themselves. With regards to corporate policy, most reforms focus on better alignment of principals and agents (e.g. compensation systems) and on the importance of focusing on long-term value rather than short-term stock price. Other reforms, of which there are dozens, focus on both of these issues as they related to the board of directors. For financial institutions themselves, policy discussion has centered on slimming portfolio size, on principal-agent problems within financial institutions, on ideas for professional or institutional directors, on proposals for better, more formal coordination of monitoring efforts among institutions and for safeguarding public funds from political pressure.

A number of other policy proposals have been discussed which may have a significant impact on governance, but which have been typically raised outside of a governance context. The most important development in this area has been the growth of Employee Stock Ownership Plans or ESOPs which are often promoted by management as a takeover defense. Under these and other circumstances the ESOP is often management controlled. Reform proposals tend to stress the importance of freeing ESOPs from managerial domination in order to make them stronger representatives of employee-owners. Most proponents view ESOPs as an excellent way to improve productivity, better align employees’ and management’s interests, and to give employees a representative role in governance. Some proponents see ESOPs as an important way to reward ‘firm specific human capital.’

Fiduciary capitalism: some unanswered questions

We now turn to a brief discussion of three questions that have arisen in this area, but to which we have no definitive answers. The following is not intended to be an exhaustive list nor an exhaustive treatment of these questions. Rather we hope to alert the reader to some important implications of current trends in corporate governance in the United States.

Can agents watch agents?

The re-concentration of ownership in the hands of institutions may, superficially, solve the Berle-Means problem, but in fact it adds one more layer of agents between the ‘real’ owners and the firms they own. Owners now have the compound agency problem of getting financial institutions to act in their best interests in getting the managers to act in their best interests. On the surface, an agency chain of this type would seem to make everything much more difficult.
Institutions are indeed charged to act in the best interest of their beneficiaries, but how is this determined and who determines it? The beneficiaries are a very diverse group – current workers and current retirees, two groups that may have different interests. To determine what is in the ‘best interest’ of beneficiaries may be a difficult or even impossible problem. In any case, it is in the broadest sense a political one. The scope for mismanagement on the part of institutions as well as their co-optation by the corporations they are supposed to monitor present serious problems. Indeed, large classes of institutions – corporate pension funds, bank trust departments – are written off as strong advocates of shareholder interests because they are thought to have been captured by management or to exist in a tight commercial network of firms in which they own stock and debt, and with which they conduct other business. The remaining active institutional investors – primarily public pension funds – are relatively free from corporate pressure, but may be subject to strong political pressure.

In summary, we feel the rise of fiduciary capitalism with its great concentrations of wealth in the hands of relatively few institutional investors raises serious concerns about the monitoring of the monitors.

Should this be a governmental function? Should it be left to the ‘market’? What role would the market play in monitoring monitors and how might it play this role? If the role of institutions is strengthened to make institutions more effective monitors, what kind of safeguards should be enacted to protect beneficiaries from institutional abuse? Is ‘fidiiciary duty’ enough to assure appropriate behavior?

What are the implications of ‘universal ownership’?
The concentration of wealth in the hands of relatively few institutions raises the important issue of how to exercise ownership when an institution, in effect, owns a significant cross-section of the entire economy – when an institution has become a ‘universal owner’, as a large institution typically becomes when it owns between 1–3% of the largest 1,000 firms.

We can think of at least two areas in which universal ownership may raise important questions.
The first is the role institutions play when they own majority stakes in all of the major firms in a single industry. If the goal is to maximize shareholder wealth and if competition within an industry is a zero sum game – or even a negative sum game – what responsibility does the institution have to ‘coordinate’ competition? At the very least, this raises major anti-trust issues. Institutions escape this problem now by being ‘portfolio’ investors – but the current thrust of monitoring and corporate governance reform is that institutions should actively try to influence companies when the need arises.

The second area in which universal ownership raises questions is with regard to public policies that may benefit the country as a whole either socially or economically, but which may adversely affect individual firms. Perhaps the simplest example is in the area of the environment. Fiduciaries as wealth maximizes would like the companies they invest in to be aggressive profit maximizes. Conceivably this could mean stretching the limits of legally acceptable behavior with regard to environmental pollution, etc. But the benefi caiaries of these fiduciaries, the ultimate owners, are also citizens who may (and judging by voting patterns and public opinion polls, do) prefer a cleaner environment. Universal ownership may, conceivably, be a way to internalize some of the externalities inherent in any economy, but the rise of strong institutional owners may also be a way to empower corporations to take actions that are narrowly profit maximizing. The fundamental question is whether public goods such as the environment, education, and health care, as well as other broad social issues, will be treated quite differently in an economy dominated by universal owners. If they are to be treated differently, how should decisions on relative priorities be made, and by whom?

What does it mean to maximize shareholder wealth?
The rise of fiduciary capitalism and its concern with corporate governance – both the market for corporate control and institutional monitoring – has taken place against a backdrop of extensive change in the basic structure of the American society. To resurrect an older theory, John Kenneth Galbraith (1956) saw the US economy as one characterized by ‘counteracting power.’ In Galbraith’s view there were three great power blocks – big labor, big business, and big government – which acted as checks and balances on each other’s excesses. The power of labor has been declining steadily for decades and the current national debate – backed up by budget proposals from both major political parties – is focused on reducing the scope, power and size of federal government. It would appear that big business may emerge as the major centre of power on the American scene,
Unchecked by a strong labor movement and unmediated by a strong central government all in a context of a growing disparity of income and wealth.

In this context what are the implications of increasing the power of institutional owners to align management with the single goal of wealth creation? Is the goal of profit maximization subject to a set of social constraints and implicit contracts between business, labor and government? (or other significant interest groups) — or is it an end in itself?

One of the ways corporations have responded to the pressure to increase profits has been to reduce costs — which frequently means laying off workers and lobbying for reduced regulatory burdens in areas such as health and safety and environmental protection. Since this typically increases the value of a company's stock, it is perfectly in line with the finance view of corporate governance. But even strong advocates of free market economics are beginning to have some misgivings about the extent of this practice. Michael Porter, a prominent Harvard Business School professor, is reported as being “discomfited by the winner-take-all nature of competition in the new economy. Rising inequality, he fears, has mired the poor even deeper in misery while stretching the middle class to the breaking point.” Porter is quoted as saying, “We can’t project the current trend very much further. I believe you will see that cycle reversed. Companies will understand the need to rebid the corporation and create a sense of community again.” (Pearlstein 1995:24)

Is a ‘sense of community’ compatible with strong institutional owners? Are these concepts contradictory or is it possible to meld the power of universal ownership with a shared sense of the common good? If so, how are institutions which are agents monitoring agents to be themselves monitored? And, in what ways are the traditional American principles of checks and balances going to apply in an age of fiduciary capitalism? In the end these may be the most important questions to ask about contemporary corporate governance in the United States.

Notes

1. For a discussion of the finance model of the corporation, see Blair (1995).

Even in an article lamenting the recent layoffs at AT&T Secretary of Labor Robert Reich recognizes the importance of the finance approach when he says, “... any chief executive who hesitates before doing everything possible to maximize returns to shareholders risks trouble.” (Reich 1995:13)


3. The exit/voice dichotomy is due to Hirschman (1970). In this context, exit refers to selling out a position when dissatisfied while voice refers to trying to modify outcomes while continuing to hold a position.


5. While the 1996 Presidential campaign, most notably that of Patrick Buchanan but of President Clinton as well, has raised the issue of downsizing and the unchecked power of Wall Street,” none of the candidates has focused on the role that institutional owners exercising their fiduciary duty might play in these events.

References


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Andrew T. Williams is an Associate Professor and James P. Hawley is Professor at the Graduate Business Programs, Saint Mary's College, P.O. Box 4240, Moraga, California 94575-4240.

"We need the courage to let go of the old world, to relinquish most of what we have cherished, to abandon our interpretations about what does and doesn't work."

Margaret Wheatley, Leadership and New Science, 1992