NEWS

SECURITIES AND
EXCHANGE COMMISSION
Washington, D. C. 20549

(202) 272-2650

Remarks to
The Exchequer Club
Washington, D.C.
December 17, 1980

"Pension Funds and Social Responsibility"

Stephen J. Friedman, Commissioner

The progressive channelling of private savings into institutional hands has been an elemental force in the American capital markets. It has transformed the shape of the securities industry, the brokerage commission rate structure and the nature of trading in equity securities. It has also had a profound effect on the role of banks in investment management. Recently there has been an increasing volume of suggestions that pension fund investments should be employed in capital-starved areas of this country and used to secure private social and political objectives, such as union organization, These suggestions require the closest examination, for they represent quite a new phenomenon in American life: encouraging the use of large aggregations of private wealth to implement social policies directly and outside of the political process.

Pension Fund Growth

The institutionalization of private savings has for the most part been a result of the growth of pension funds. That growth has been truly astonishing. In 1940 total public and private pension assets were less than \$3 billion. Today that sum is more than \$400 billion (excluding the Federal Retirement System) and some analysts predict that by 1990 pension funds will account for almost half of the external capital invested in American corporations.

Trading in equities has become very much an institutional world. The New York Stock Exchange recently reported that institutions account for 70% of trading on the exchange. Others estimate that institutions own more than 35% of all outstanding stock.

The Securities Markets

The effect of pension fund growth on the public securities markets has been extraordinary. It gave rise to a profusion of specialty brokerage firms in the 1960's and early 1970's that offered services designed to appeal to the institutional market. The size of institutional trades made the existing New York Stock Exchange commission structure extremely profitable, but also exposed the inefficiency of those administered prices in an environment of heavy institutional trading. The high profits generated a wide variety of nonprice competition -- chiefly in research services -- for the institutional dollar. Ultimately, that system collapsed under its own weight, leading to negotiated commissions and an adjustment process that was a major factor in the disappearance or merger of many major New York Stock Exchange firms.

The impact of pension fund growth did not end with the disappearance of fixed rates and the specialized firms they spawned. The shift in trading from individual investors to institutions has resulted in some loss of traditional forms of liquidity in the public auction markets. Often a dealer must be interposed as a block positioner between a selling institution and the purchasers -- a dealer with the capital and will to take any intervening inventory risk. The resulting need for capital has been a powerful force for concentration in the securities industry, and it has even led some to view bank participation in the securities markets in a new light.

The growth of pension funds has also meant that banks and insurance companies have become the major factors in American investment management. In 1976, a survey of the 300 largest money management firms in the United States showed that 70% of the assets under management were held by banks and insurance companies. That development has resulted in the concentration of investment management control over very large amounts of capital in relatively few hands, a fact which has important consequences for the exercise of shareholder rights and for the neutrality of the market mechanism on social and political issues.

Neutrality in Investing

The separation of ownership and control in American business, and the implications of that fact for the role of shareholders, has been a subject of intense interest in this century. The deep difficulty of those questions is reflected in the fact that they keep surfacing -- most recently in the debate about corporate accountability and the use of the proxy mechanism to obtain disclosure about social and political issues. The linkage between that set of questions and institutional ownership of equity securities is only beginning to be widely appreciated. But it is critical.

Americans have a history of ambivalence toward large concentrations of wealth. While our society generated the largest independent business organizations in the world, it also generated a bewildering profusion of laws and regulations to limit the economic and political reach of their power. In a market system, pursuit of the profit motive, properly regulated, has been viewed as politically neutral, with social benefits from economic activity arising from the jobs, income, wealth and efficient allocation of capital that result. If the side effects are not acceptable for society, it is the function of government, not business, to reshape economic activity. The separation of the private and public functions has been campaign contributions and requires disclosure of lobbying activities.

Of course, economic activity is not neutral. In our history, workers have been exploited, neighborhoods have been razed by developers and private arms sales have been made to unsavory actors abroad. Investments have been made in enterprises that harm the public. But the basic allocation of function in our society leaves the remedy to government rather than those in control of industry or financial institutions. Accordingly, we should look skeptically at suggestions that tend to politicize the investment process.

<u>The Corporate Franchise</u>

In the voting of shares, the principle of neutrality was thought to be reflected in the so-called "Wall Street Rule," under which institutional investors vote with management unless they are dissatisfied -- in which case the shares are sold. A number of questions come to mind:

-- does voting make any difference at all?
-- does the Wall Street Rule represent neutrality?
-- should institutions exercise an independent voting policy?
-- should the vote be passed through to the beneficiaries?

First, does voting make any difference? We have been wrestling with that question at the Commission, because it underlies so much of the debate about the proxy rules and social responsibility issues. It may be useful to ask that question a slightly different way. Does the market mechanism alone supply sufficient discipline for management? Would we be comfortable with a system involving publicly held nonvoting shares and self-perpetuating Boards of Directors which could be removed only if there is a change in control?

On balance, most of us would probably answer that question in the negative. Even if the pricing mechanism is highly efficient, the ability of many companies to avoid raising equity capital in the public securities markets has permitted managements to avoid the effects of market discipline. To be sure, aggressive takeovers have provided an alternative market discipline -- but only in a limited class of cases. The largest companies are immune to a contested takeover bid from all but a few of their equals. Moreover, the proxy fight has come back into vogue as an alternative takeover device, and there are enough other examples of the importance of voting to make me reluctant to abandon it as a mechanism of corporate accountability. Finally, our experience with self-perpetuating boards in mutual institutions does not make a compelling case for the widespread use of a practice that has the effect of perpetuating management.

If the corporate franchise is important, its utility is undercut by an automatic vote for management. A weak management could not ask for a better system, for it tends to neutralize the power of other blocks of stock. On the other hand, it would not suffice to say that an institution should simply withhold its vote. As the percentage of institutional ownership of American business grows, the neutralization of that vote simply magnifies the power of other significant blocks of stock. In fact, there is no neutral position.

In the absence of neutrality, what is an investment manager to do? Our staff recently completed a study on corporate accountability in which it noted that many institutions have developed procedures for voting corporate proxies. It suggested that all institutions should do so and should also establish criteria for determining how they will be voted; moreover, it suggested that the institution disclose the procedures and criteria and the extent to which its voting of shares was consistent with those criteria.

There are limitations to this approach. It works well if the issue to be voted on is essentially economic -- how has management performed? Should a reorganization be authorized? When the power to manage the fund is given to a bank or other investment manager, it is fair to say that the power to vote on those issues goes along as well. They are part and parcel of the investment process.

The 1970's saw the proliferation of a whole new set of issues for shareholders -- disclosure about matters like environmental pollution and participation in trade with certain countries -- that really ask the question, "Do I want to be associated as an investor with a particular kind of conduct?" Moreover, as American business speaks out more on broad political issues -- an activity which the Supreme Court has determined to be conduct protected by the First Amendment -- this question of association will be sharpened. With respect to these questions, it is not at all clear that the judgment should be made by the investment manager rather than the owner.

It is one thing to say that I have delegated to my investment manager the power to approve corporate mergers involving portfolio companies. It is quite another to say that I have delegated the power to approve use of corporate funds to support a particular political or economic policy.

But in the case of a pension fund, who is the "I"? Is it the employer? The union? The individual employees? That is not a question that ought to be answered on the basis of legal title to the securities. We ought not to have a different answer for an internally managed fund, a bank trusteed fund, and an insured fund, each of which involves essentially the same social institution but yields different answers to the question of legal title. Nor is it very satisfactory to say that in a defined benefit plan, where the fund is a way of insuring the employer's obligation to pay a fixed benefit, the employer is the real party in interest, but in a defined contribution plan, where what the employees receive is determined by investment performance, the views of the employees should control.

There are many possible ways to deal with this problem: passing the vote through pro-rata to the employees, allowing an employee-representative group to vote and requiring it to report its actions (on the PAC model), employing a joint committee, and so forth. In principle, I favor passing the vote back to the employees, but I fear it is both impractical and costly. In the absence of that diffusion of voting power, we are faced with the possibility of putting a formidable weapon into the hands of the employer or the union. And when the the questions presented for a vote strike close to the interests of the voter, then the principle of neutrality recedes far into the background.

Suppose a resolution is put to the shareholders requiring a company to stop resisting unionization? Or to keep its plants in the Frost Belt? Is it good for our society if labor representatives determine that issue for a portfolio company in accord with their views of what is good for their members who are employees of different companies? On the other side of the coin, would we want an employer to answer that question for another company in accord with its own interests? Because of these concerns, my own views favor a joint arrangement, since the self-interest of each side tends to cancel that of the other.

Investing to Achieve Social and Political Goals

I would like to explore these issues in a slightly different context. To what extent should investment of pension funds -- as opposed to merely voting the shares -- reflect the social or economic views of the employer, the employees or the investment manager? The Industrial Union Department of the AFL-CIO has recently suggested that, in collective bargaining, unions should reach out for greater participation in the management of pension funds. It concluded that a significant portion of union pension funds is being invested in ways that are not consistent with the long-term interests of employees -- particularly in non-union companies and companies which have moved substantial activities overseas. Suppose the same approach were applied to companies which:

-- trade with the Soviet Union,
-- manufacture missile guidance systems, or
-- publish books taking a position on abortion or gun control?

I could go on, but the point is obvious. Each of these is a highly emotional political issue on which thoughtful people come to sharply different conclusions. Most of us have no difficulty with the idea that individuals can determine that they do not want to be associated with a company that manufactures a given product. Indeed, within their zone of choice among equally attractive investments, portfolio managers make decisions of that kind all the time. But when the individual becomes a bank controlling many billions of dollars in pension assets, or a union movement with even broader scope, and when the bank or union invests in accordance with predetermined instructions, then the whole picture changes dramatically. It raises at least three concerns:

-- the private impact on the effectuation of public policy
-- the use of power from wealth accumulated in a fiduciary capacity
-- the concentration of economic power

First, issues of this kind are customarily resolved in the political process. The constitutional system was carefully designed to permit the airing of all views bearing on a contentious issue and to resolve the clash of competing interests by compromise. For example, Congress has attempted to strike a careful balance between labor and management in the labor laws. A concerted private effort to withdraw capital from securities of nonunion companies would surely affect that balance, perhaps significantly. Even if one believes the balance should be readjusted, the readjustment should take place through the Congress, not through the use of private economic power.

Second, the bank trustee and the insurance company acquire managed assets as fiduciaries. It would surely be inappropriate for them to pursue their own social and economic goals with the power conferred by the accumulated wealth of others. To a significant degree, the same can be said of the employer and the union. It is fair to conclude that the pension funds represent deferred wages, and they are aggregated only to provide security for the deferred obligation. In that sense, they may be said to be "owned" by the employees. It would be possible, I suppose, for an employer or union to seek employee approval for the administration of these funds in accordance with stated political or social principles. But I cannot help doubting whether the approval process is really meaningful.

Finally, I suspect that one of the reasons this country has been prepared to tolerate so easily the accumulation in private hands of pension funds of this very large size is precisely because of the neutrality of the investment process. If the 20 largest financial institutions had used the more than $100 billion in equity investments they control to help put their social views into effect, we can easily guess at the legislative response. I doubt that the response would be much different if it were unions asserting control over assets for the same purpose.

In my judgment, this is not a passing issue. Power that is not firmly anchored tends to be seized. The growing power and importance of pension funds, the great multiplicity of claims on scarce capital resources, and the hands-off attitude that has characterized what I have called the neutral investment process, all conspire to make pension funds a juicy target. As competing rights in the employment of those funds are asserted, we will be faced with finding new ways to control this potent new force.