Shareholder Democracy:

The Roots of Activism and the Selection of Directors

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Integrated Risk Management and Corporate Governance can raise many issues related to the relationship between shareholders and directors. This Article will address four related topics. First, it will describe the concerns that have arisen from shareholder activism. Second, it will provide an overview of the origin and inevitability of increased shareholder activism.[1] Third, it will discuss a fundamental issue arising from shareholder activism, namely how public companies elect their directors. Fourth, it will review shareholder democracy and shareholder access to corporations as required by the SEC, specifically focusing on an unusual procedure used historically by the Teachers Insurance and Annuity Association-College Retirement Equities Fund ("TIAA-CREF").

Shareholder activism is driven by a deep political change arising from the rapidly developing structure of private pension plans.[2] That change is accelerating and intensifying, and the director election process is exactly the type of issue that can animate the interests and expectations of a coalition of pension participants and investors.[3]

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1. One of the most contentious issues has been the issue of shareholder access to a public corporation's proxy solicitation for director nominations and elections. Thus far, business interests have impeded the SEC's ability to grant shareholders greater access to management's proxy statements. Shareholders who wish to nominate director candidates must bear the expense of creating their own proxy solicitation. *See* Lionel Barber & Jeremy Grant, *SEC to Re-open Proxy Access in 2008*, FIN. TIMES, Nov. 1, 2007, *available at* http://www.ft.com/home/us (search "SEC to Re-open Proxy Access in 2008").

2. Gerald F. Davis & Tracy A. Thompson, *A Social Movement Perspective on Corporate Control*, 39 ADMIN. SCI. Q. 141, 154 (1994).

3. A stockholder's ability to participate in corporate governance through the election of directors is, in theory, a fundamental part of corporate law; there is a general policy against improper disenfranchisement of stockholders. *See* Blasius Indus., Inc. v. Atlas Corp., 564 A.2d

Ultimately, the best solution will come from years of corporate debate and negotiation, which will produce a creative solution that avoids the harms and risks currently feared by management advocates. In the meantime, the SEC should permit shareholder proxy resolutions on the subject to move forward.[4]

To illustrate the vigorous debate among corporate leadership, it is useful to point out a few quotes. First, consider Martin Lipton's keynote address on February 7, 2007, to the 25th Annual Institute on Federal Securities.[5] That address had the ominous and apocalyptic title, the "Eclipse of the Public Corporation."[6] Mr. Lipton, one of the most distinguished and thoughtful corporate attorneys in the country, decried the "shift in the board's role from guiding strategy and advising management to ensuring compliance and performing due diligence."[7] A second concern was whether the new environment would make directors and companies so risk averse that they will "lose the entrepreneurial spirit that has made American business great."[8] The drivers of Lipton's concerns are new corporate regulations and, as he states in his concluding sentence, "rampant, unrestrained, and unregulated shareholder activism."[9]

In response, Gretchen Morgenson characterized Mr. Lipton's talk in the *New York Times* under the headline *Memo to Shareholders: Shut Up*.[10] Jack and Suzy Welch have also expressed their concerns about shareholder activism in an issue of *Business Week*. They stated that they

651, 663 (Del. Ch. 1988) (holding that a corporate board breached the duty of loyalty to its shareholders by violating shareholder voting rights).

4. The SEC most recently proposed significant proxy access reform in late 2003; this proposal has not been adopted. *See* Security Holder Director Nominations, 68 Fed. Reg. 60,784 (proposed Oct. 23, 2003) (the proposed rules would, "under certain circumstances require companies to include in their proxy materials security holder nominees for election as director").

5. Martin Lipton, Keynote Address to the 25th Annual Institute on Federal Securities: Shareholder Activism and the "Eclipse of the Public Corporation" (Feb. 7, 2007), *available at* http://blogs.law.harvard.edu/corpgov/files/2007/02/20070210%20Lipton%20Address.pdf.

6. The title is borrowed from a 1989 Harvard Business Review article. *See generally* Michael C. Jensen, *Eclipse of the Public Corporation*, 67 HARV. BUS. REV. 61, 61–62 (1989) (discussing the move away from public stock ownership in the United States).

7. Lipton, *supra* note 5, at 2.

8. *Id.*

9. *Id.* at 10.

10. Gretchen Morgenson, *Memo to Shareholders: Shut Up*, N.Y. TIMES, Feb. 11, 2007, § 3, at 1.

felt troubled by the lack of constructive dialogue in the board room and described directors as "too paranoid." [11]

Henry Manne, Dean Emeritus of the George Mason University School of Law and an expert on the law and economics of markets and corporations, wrote a long op-ed piece in the January 2, 2007, edition of the *Wall Street Journal*, entitled *The "Corporate Democracy" Oxymoron*.[12] He vigorously attacked the idea that the SEC might "facilitate direct shareholder nomination of directors."[13] He based his argument on the assumption that activist investors are interested "in social causes, political movements or the reallocation of wealth," when they should be "interested exclusively in maximizing their return on investment."[14]

John Castellani, the savvy and experienced president of the Business Roundtable, in a memo dated January 20, 2007, warned that "direct access to the ballot for board candidates . . . could fundamentally transform the way we do business in this country."[15] According to Castellani, direct access to the proxy could also "turn corporate board rooms into battlegrounds for every political issue and agenda other than the long-term growth of the companies," with battles "on every issue from genetically-engineered food to animal welfare standards."[16]

In its lead editorial on November 27, 2006, entitled *Board Games*,[17] the *Wall Street Journal* attacked the idea of "shareholder democracy" and direct access by any shareholders, large or small, to the director election process.[18] It argued that activist shareholders "tend to be union-dominated pension funds, with ambitions for turning board rooms into new political battlegrounds."[19]

In a March 2, 2007 op-ed piece in the Wall Street Journal, Tom Perkins, the legendary venture capitalist, contrasted how a venture capital board helps companies succeed, as compared to a public company board, which focuses on process and reviews the actions of

11. Jack and Suzy Welch, *The Boardroom Bunker—Too often the question is: "Has anything happened lately that could embarrass us?"* BUS. WK., Dec. 25, 2006, *available at* http://www.businessweek.com/perm/content/06_52/b4015170.htm?chan=search.

12. Henry G. Manne, *The "Corporate Democracy" Oxymoron*, WALL ST. J., Jan. 2, 2007, at A23.

13. *Id.*

14. *Id.*

15. John Castellani, *Market Risk*, WALL ST. J., Jan. 22, 2007, at A10.

16. *Id.*

17. Editorial, *Board Games*, WALL ST. J., Nov. 27, 2006, at A12.

18. *Id.*

19. *Id.*

management.[20] He labeled this a "Compliance Board" as opposed to a "Guidance Board."[21] He further criticized and attacked the Compliance Board as "newly gender and racially inclusive," and focused on legal issues and compliance with the SEC, NYSE, and Sarbanes-Oxley.[22]

Finally, Peter Drucker, in a 1976 book entitled *The Unseen Revolution: How Pension Fund Socialism Came to America*, stated that "[i]f 'socialism' is defined as 'ownership of the means of production by workers'—and this is both the orthodox and the only rigorous definition—then the United States is the first truly 'Socialist' country."[23] Under this theory, the new shareholder activism does not exclusively arise from union-dominated, politicized pension funds but instead gains powerful thrust and scope from an extraordinary alliance of employees and individual investors, represented by a broad array of institutional investors.[24]

This is a serious set of warnings that should concern all of us in the rapidly changing corporate governance environment. After all, the corporation is the central economic institution in our society

It is also interesting to note, however, how one company, TIAA-CREF, achieved extraordinary economic success over a 70-year period, and arguably the most remarkable sustained growth of any financial institution in America. It performed all that with regularly contested director elections, a gender and racially mixed board, and a non-profit charter. All these results and performances were achieved without a single acquisition.

Where did all this "rampant, unrestrained and unregulated activism" come from? It could be that Marty Lipton mistakes a symptom for the cause in dating it from the founding of the Institutional Shareholder Service ("ISS")[25] in 1985 by Bob Monks and Nell Minow, along with

20. Tom Perkins, *The "Compliance" Board*, WALL ST. J., Mar. 2, 2007, at A11.

21. *Id.*

22. *Id.*

23. PETER F. DRUCKER, THE UNSEEN REVOLUTION 1 (1976).

24. *Id*. at 1–3.

25. Institutional Shareholder Services, Inc., provides proxy voting and corporate governance solutions. It provides proxy research, proxy voting services, solutions for compliance, social and governance tools, and risk management. Institutional Shareholder Services, Inc. was founded in 1985 and is headquartered in Rockville, Maryland. As of January 2007, Institutional Shareholder Services, Inc., operates as a subsidiary of RiskMetrics Group, Inc. RiskMetrics Group, ISS Governance Services, http://www.issproxy.com/issgovernance.html (last visited Feb. 24, 2008).

the emergence of the California Public Employees' Retirement System ("CalPERS")[26] as an outspoken critic of corporate America.

To the contrary, I would assert that the cause was rooted in the enactment of the Employee Retirement Income Security Act ("ERISA")[27] in 1976 where the seeds of death for Defined Benefit ("DB")[28] and the seeds of dramatic growth for Defined Contribution ("DC")[29] plans were sown. Along with heavy regulatory compliance, ERISA created the costly Pension Benefit Guaranty Corporation ("PBGC").[30] Someone with perfect foresight could have seen that ERISA would end employer sponsorship of DB plans.

Interestingly, one of the keenest observers of U.S. pensions, Peter Drucker, did not foresee that his pension socialism would never come to America with the predominance of DB plans. Such plans largely obscure the losses to individual participants due to the sponsors' commitments to fund them. However, ERISA also paved the way for a true revolution, in creating the Individual Retirement Account ("IRA")[31]

26. CalPERS provides pension fund, healthcare, and other retirement services for approximately 1.5 million California public employees. CalPERS, Facts at a Glance, http://www.calpers.ca.gov/eip-docs/about/facts/general.pdf. As of April 2008, it owns $248.4 billion worth of stock, bonds, funds, private equity, and real estate, making it the largest public pension fund in the United States. CalPERS, Investment Facts, http://www.calpers.ca.gov/eip-docs/about/facts/investme.pdf; *see also* CalPERS Facts at a Glance, http://www.calpers.ca.gov/index.jsp?bc=/about/facts/home.xml (last visited Feb. 24, 2008) (providing a detailed explanation of these figures as well as additional CalPERS statistics); CalSTRS, CalSTRS at a Glance, http://www.calstrs.com/about%20calstrs/ataglance.aspx (last visited Feb. 23, 2008) (providing information and statistics related to CalSTRS (California State Teacher Retirement System), including membership numbers, assets, income sources and benefits).

27. Employee Retirement Income Security Act, 29 U.S.C. §§1001, et seq. (2000).

28. Under 26 U.S.C. § 414(j), a defined benefit plan "means any pension plan that is not a defined contribution plan." 26 U.S.C. § 414(j) (2000).

29. 26 U.S.C. § 414(i) states: "the term 'defined contribution plan' means a plan which provides for an individual account for each participant and for benefits based solely on the amount contributed to the participant's account, and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to such participant's account." 26 U.S.C. § 414(i)(2000).

30. The Pension Benefit Guaranty Corporation is an independent agency of the United States government created by ERISA to encourage the continuation and maintenance of voluntary private pension plans, provide timely and uninterrupted payment of pension benefits, and keep pension insurance premiums at a minimum. Pension Benefit Guaranty Corp., Who We Are, http://www.pbgc.gov/about/about.html (last visited Feb. 23, 2008). Defined benefit pension plans promise to pay a specified monthly benefit at retirement, commonly based on salary and years on the job. *Id*.

31. Investment Company Institute, Frequently Asked Questions about Individual Retirement Accounts (IRAs), http://www.ici.org/401k/faqs_iras.html (last visited Feb. 23, 2008). An Individual Retirement Account, or IRA, is the most basic sort of individual retirement arrangement, in that it is typically funded directly by individuals. Although many tend to think of an IRA as something that individuals arrange, an employer can facilitate the creation and funding

and making possible the subsequent spectacular growth of DC plans through the 401(k) mechanism. Over half of the $16 trillion of pension savings are now in DC plans with IRAs and 401(k)s dominating—there are over $3 trillion in each of these funds as of December 31, 2006.[32] The prediction is that their growth will steadily continue, if not accelerate. Many suggest this outcome is another unintended result of the harsh provisions of the Pension Protection Act of 2006.[33]

The fundamental characteristic of IRAs, 401(k)s, and other DC plans is that the worker/participant/family has a direct interest in the outcome of the plan's investments. In addition, the stocks of public companies represent the core investment of almost all such plans.

The Public Company Accounting Oversight Board ("PCAOB")[34] estimates that fifty-five percent of American families now own stock in public companies, mostly through their DC plans and IRAs. Another large percentage own stocks through their state and municipal multi-employer plans where contributions, taxes, and benefits are all determined, in great part, by the investment results of the stocks held in public companies.

Peter Drucker, writing in 1976, could not foresee any of these changes and developments. A simple change in structure of U.S. pensions would lead to a very different politics of workers in a strange alliance with investors.

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of IRAs as well. Under an IRA arrangement, what the employee gets at retirement depends on the funding of their IRA and the earnings (or income) on those funds. The rapid growth of IRAs is due to the roll-over of 401(k) accumulations upon an employee's retirement. The Internal Revenue Service provides a detailed explanation of the requirements and procedures involved in establishing an IRA account. Internal Revenue Service, Retirement Plans FAQs regarding Simple IRA Plans, http://www.irs.gov/retirement/article/0,,id=111420,00.html#1 (last visited Feb. 24, 2008).

32. Peter Brady & Sarah Holden, *The US Retirement Market, 2006*, RESEARCH FUNDAMENTALS (Investment Company Institute, Washington, D.C.), July 2007, Vol. 16, No. 3, at 2, *available at* http://www.ici.org/pdf/fm-v16n3.pdf.

33. Pension Protection Act of 2006, Pub. L. No. 109–280, 120 Stat. 780 (codified in scattered sections of Title 26 and 29 of the U.S. Code).

34. The Public Company Accounting Oversight Board "is a private-sector, non-profit corporation created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies." Public Company Accounting Oversight Board, http://www.pcaobus.org/index.aspx (last visited Feb. 23, 2008). Its stated purpose is to "protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports." *Id*. Although a private entity, the PCAOB has many government-like regulatory functions, making it in some ways similar to the private Self Regulatory Organizations ("SROs") that regulate stock markets and other aspects of the financial markets in the United States. *See id*. (describing the role and functions of the PCAOB).

Bob Monks, Nell Minow, and CalPERS simply saw the role for institutional investors before others.[35] TIAA-CREF also became the first private institutional investor to begin challenging corporate America on a range of issues. TIAA-CREF is a DC plan, using section 403(b) of the IRS Code, that serves several million higher education employees. Those employees have invested a significant amount of their pension assets in CREF stock accounts. In 1993, TIAA-CREF was the first institutional investor to publish a statement on good corporate governance,[36] with the specific purpose of explaining how shareholders would vote their proxies.

Consider the political power of fifty-five percent of American families having ownership in public companies. Didn't that have something to do with the unanimous Senate vote passing Sarbanes-Oxley? When fifty-five percent of American families saw what happened to their investments after Enron, WorldCom, and other corporate scandals, they lost faith in the integrity of all American companies. A harsh law resulted. The auditors paid a higher cost than the directors, being the first major American profession to earn the privilege of having a federal regulator, a privilege not held by either lawyers or doctors.

Besides direct political action in Congress, the new coalition of workers and investors naturally results in increased shareholder activism as both workers and shareholders are energized by issues of common concern. For instance, currently they may view what they believe is an unfair capture of "rents" in the form of excessive management compensation, permitted by a lax board oversight.

One can imagine the energy such an issue would bring to the usual activists. The state pension systems would see a political advantage in attacking this issue—whether by seeking shareholder advisory votes on compensation directly, or seeking ways to change the perceived laxness of the shareholder elected boards. The now widespread adoption of "majority voting" provisions is an example of the results of this activism. Another result is the issue of direct access to the proxy to create contested ballots.

Not long ago, union pension plan activism was focused on local management issues, using the proxy mechanism for individual company

35. ROBERT A.G. MONKS & NELL MINOW, CORPORATE GOVERNANCE 120–21, 142–43 (1995).

36. *Id.*; *see also* TIAA-CREF, Policy Statement on Corporate Governance, Mar. 13, 2007, *available at* http://www.tiaa-cref.org/pubs/pdf/governance_policy.pdf (detailing TIAA-CREF's history, election and governance rules, and policies).

harassment in support of local negotiations. They have now moved to more global issues[37] as they join other pension plan activists in attacking matters that reflect the huge perceived gap in executive compensation and their members' limited wage growth and reduced job security. They have added well-versed lawyers to their staffs who understand SEC rules, corporate by-laws, and the other various mechanisms of corporate governance.

Most recently, the American Federation of State, County, and Municipal Employees ("AFSCME") sought to put a resolution on AIG's proxy statement asking the company to permit direct access to the ballot by shareholders in director elections.[38] The management opposed this option, supported by the SEC, and the union took their argument to the courts where they won.[39]

The SEC and corporate America realize the potency of this issue—hence the strength of concern expressed at the beginning of this article. One would have suspected that a conservative, more business-oriented SEC would be immediately sympathetic to the corporate arguments. However, the SEC has hesitated to take up the matter. The SEC's caution with this issue seems to be a growing recognition of the political clout of a coalition of shareholders, together with the fifty-five percent of American families whose pensions are directly affected by corporate performance.

More significantly, this is the kind of issue that can bring out investor-oriented institutions such as mutual fund companies that invest 401(k)s and IRA savings, and hedge funds that are steadily gaining more pension investors. Incidentally, the hedge fund role in pension fund investing was expanded by Congress in the recently enacted Pension Protection Act of 2006.[40]

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37. *See, e.g.,* United Auto Workers, About UAW, Who We Are, http://www.uaw.org/about/uawmembership.html (last visited Feb. 23, 2008) (listing UAW's global membership); Labor Net, About LaborNet, http://www.labornet.org/about.htm (last visited Feb. 23, 2008) (describing its goals "to build a democratic communications network for the labor movement" throughout the world); United Steel Workers, Campaigns, http://www.usw.org/usw/program/content/campaigns.php (last visited Feb. 23, 2008) (USW's campaigns range from organizing Boston taxi drivers to organizing a "global super union").

38. Lorraine Woellert, *HP Fight Forecasts Stormy Proxy Season*, BUS. WK., Jan. 24, 2007, *available at* www.businessweek.com (search "HP Fight Forecasts").

39. Am. Fed'n of State, County & Mun. Employees v. Am. Int'l Group, Inc., 462 F.3d 121, 131 (2d Cir. 2006).

40. ERISA rules make hedge funds and their managers "trustees" if more than twenty-five percent of the fund's assets are pension assets. The Pension Protection Act of 2006 removed public pension funds from the twenty-five percent calculation. Pension Protection Act of 2006, Pub. L. No. 109–280, 120 Stat. 780 (2006).

The self-appointing character of how directors of public companies are elected has long been an awkward matter for boards to explain, in light of the perceived democratic process that shareholder ownership suggests. The single slate of directors to "choose" from doesn't square with American ideas of democracy.[41] The legitimacy of American companies is crucial to their franchise and academic arguments—like Henry Manne's calling corporate democracy an oxymoron[42]—simply won't be accepted; they seem specious and tortured.

Yet, virtually everyone in the corporate world think direct access to the proxy by shareholders is a serious threat to good corporate governance.[43] The arguments against shareholder democracy are articulated in the earlier quotes: "social agendas will be pursued," "a minority will control the board," and "it will be the end of collegiality." Other arguments heard from respected leaders in governance and finance include: "I would not be willing to run in a contested election," and "our already weakened defenses against inappropriate takeover attempts would be lost."

It is interesting to consider how such a contested election would actually work. What would the proxy ballot look like? Would the directors list the names they recommend and the shareholders' names? And would they be elected on a simple plurality basis? Or would there be entire slates? And, of course, the really hard question is how to select the shareholders eligible to put names in play.

The SEC several years ago proposed a way for institutional shareholders to nominate a director or directors. The proposal was controversial and had so much opposition that it was finally dropped.[44]

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41. JAY W. LORSCH & ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 20–23 (1989) (describing the selection and election process); *see also* Charles M. Elson, *Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure*, SMU L. REV 127, 158 (1996) (stating that "board members are usually selected by the chairman or other senior management, and they possess extensive professional and personal ties to the officers that compromise their effectiveness as monitors"); Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence,* 90 NW. U.L. REV. 898, 915–16 (1996) (stating that directors often have "social ties with members of management, represent entities that can benefit from existing or potential business relationship with the management, or both").

42. *See* Manne, *supra* note 12 (describing Manne's views on corporate democracy).

43. Lynne L. Dallas, *The New Managerialism and Diversity on Corporate Boards of Directors*, 76 TUL. L. REV. 1363, 1384–85 (2001) (listing shareholder proposals to increase diversity on boards).

44. In 1977, the SEC again focused on security holder access to company proxy materials regarding the nomination and election of directors during its broad review of security holder communications, security holder participation in the corporate electoral process, and corporate governance generally. In anticipation of public hearings held in September 1977, the

The AFSCME[45] proposal is to permit director election procedures to be placed on proxies on a precatory basis—not to actually force companies to take an action.[46] Without dictating a single solution, this can create a climate for the discovery of a reasonable one. There are some good examples of imaginative corporate secretaries and their corporate lawyers finding compromises to difficult questions like direct access. Majority voting is an excellent example. Hopefully the SEC will permit the debate to go on for a few years in the expectation that a livable solution will be discovered.

But let me describe one imaginative and successful way contested ballots did work at TIAA-CREF from its implementation in 1922 (but planned in the 1918 founding documents of the company) to 1988.

The information for the TIAA-CREF contested ballot process comes from a history of the company written by William Greenough, a former long-term CEO, entitled *It's My Retirement Money: Take Good Care of It.*[47] Bill is best known for his invention of the variable annuity,[48]

Commission, without formally proposing rule changes, requested comment on a number of issues, including whether "shareholders [should] have access to management's proxy soliciting materials for the purpose of nominating persons of their choice to serve on the board of directors." Reexamination of Rules Relating to Shareholder Communications, Shareholder Participation in the Corporate Electoral Process, and Corporate Governance Generally, 42 Fed. Reg. 23,901 (Apr. 28, 1977).

45. American Federation of State, County, and Municipal Employees ("AFSCME"), http://www.afscme.org/ (last visited Feb. 23, 2008).

46. In *Am. Fed. of State, County & Mun. Employees v. Am. Int'l Group, Inc.*, the court held that "a shareholder proposal that seeks to amend the corporate bylaws to establish a procedure by which shareholder-nominated candidates may be included on the corporate ballot does not relate to an election within the meaning of the Rule and therefore cannot be excluded from corporate proxy materials under that regulation." Am. Fed. of State, County & Mun. Employees v. Am. Int'l Group, Inc., 462 F.3d 121, 123 (2d Cir. 2006). Specifically, the court interpreted Rule 14a–8's election exclusion as "applying to shareholder proposals that relate to a particular election and not to proposals that, like AFSCME's, would establish the procedural rules governing elections generally." *Id*. at 129–30.

47. WILLIAM C. GREENOUGH, IT'S MY RETIREMENT MONEY, TAKE GOOD CARE OF IT: THE TIAA-CREF STORY 261–78 (1990).

48. *Id.* at 77–135. TIAA-CREF developed the variable annuity to help its pensioners when high inflation and low interest rates followed World War II. In the Roaring 20s, stocks and the economy were hot in the United States and so was inflation, which eroded the value of fixed pensions. *Id*. at 81–82. Teachers Insurance and Annuity Association ("TIAA"), formed in 1918, was in its early years, but leaders of the New York-based nonprofit understood that pensions funded in fixed-dollar investments couldn't keep up with inflation. *Id*. at 33, 48–51. The market crash of 1929 and the Great Depression that followed shelved any plans for inflation-fighting products, but the high inflation and low interest rates following World War II sparked new action. *Id*. at 65–67. Relying on a study he conducted that found a correlation between the stock market and inflation, TIAA's William Greenough changed annuities forever. *Id*. at 83–85. The doctor of philosophy in economics led a team of actuaries and attorneys to develop a new payout mechanism, one measured in units rather than dollars, with the value of the units based on their

CREF, which has made retirement for thousands of professors prosperous well beyond their expectations.

The founders of TIAA in 1918 wanted some true policyholder democracy in the election of, at least, some of the trustees—in contrast to the typical single, unopposed slate of most commercial companies.[49] In order to get the result, they set up a freestanding Policyholder Nominating Committee, originally appointed by the Board of sixteen trustees who were named by the organizing entity, the Carnegie Corporation, and renewed through the usual self-selection or single slate process.[50] The Policyholder Nominating Committee also became a self-selecting entity but independent of the other trustees.

Starting in 1921, the Committee nominated five candidates each year, primarily from higher education, and one of them was elected by weighted voting (five points for first preference, three for second, and one for third). Because trustees were elected for four years, eventually four sitting trustees of twenty were so elected. There were sixty-nine policyholder selected trustees over the lifetime of the Policyholder Nominating Committee. Subsequently, with the creation of CREF as a separate company, the system was modified to nominate three trustees for each board with one to be elected.

A surprisingly large number of TIAA, and later CREF, participants actually voted, ranging from eight to thirty percent, far higher than the less than one percent who voted for mutual life insurance company single slate directors.

Several trustees so elected came in hostile to the policies of the company, but quickly became good colleagues of the other trustees and advocates for the company. Perhaps the most distinguished of such "initially hostile" trustees was Paul Samuelson,[51] who was elected after

underlying investments. *Id*. at 84. By 1951, Greenough and his team had invented the variable annuity. *Id*. at 85–86. By virtue of a system tied to units, annuitants' payouts could be adjusted annually, depending on investment performance and the assumed investment rate at the beginning of the payout stream. *Id*. at 99–103. Greenough's team included Robert Duncan, a fellow of the Society of Actuaries, who developed the mathematics. *Id*. at 99. His model is still in use today, except that annuitants may now choose payouts that change monthly instead of annually. *Id*. at 99–103.

49. *Id*. at 265.

50. *Id*. The Carnegie Foundation formed TIAA-CREF in New York City in 1918 as the Teachers Insurance and Annuity Association of America, with an endowment of $1 million from the Carnegie Corporation of New York. *Id*. at 263. The company's mission was to provide life insurance and retirement plans to professors and employees of colleges and universities. *Id*.

51. Paul Samuelson won the Nobel Prize in Economics in 1970. Along with Kenneth Arrow, Samuelson is considered one of the founders of modern neoclassical economics. The Nobel Foundation, Nobel Prizes: Biography of Paul Samuelson, http://nobelprize.org/nobel_prizes/

a bad patch of investment performance. Prof. Samuelson was renewed for multiple terms until he retired because he hit the mandatory retirement age. He turned out to be the leader in shaping the company's investment policies in the 1970s and 80s.

After CREF was formed, five Nobel Laureates and a number of other distinguished economists came on the Boards through the Policyholder Committee process. Some of them did not have an easy way of relating with board members—some Nobelists had a hard time understanding the word "collegial"—but they all contributed to the remarkable progress and growth of the company.[52]

Since CREF was created before legal resolution of whether a variable annuity was an "insurance contract" subject to state law, or a "security" subject to the federal security laws, the SEC exempted it from compliance with the Investment Company Act of 1940. For a variety of reasons, the company agreed to submit to SEC regulation in the mid-80s. Ironically, the Policyholder Nominating Committee violated the direct shareholder voting requirement, a requirement embedded deep in SEC regulations and interpretations.

Briefly, TIAA-CREF's financial success in the period of this practice was extraordinary. By 1988, the assets of the combined entities for both TIAA and for CREF exceeded the life insurance assets for any other company in the United States. The company first applied for credit ratings in 1990 and easily earned Triple-A ratings from all agencies.[53]

Yet, TIAA-CREF was a narrowly focused company with one set of products, and severely restricted by its tax exemption to one market: higher education.[54] Critics of nonprofit cultures, of large and well-diversified boards with true shareholder-elected boards, may describe TIAA-CREF as an outlier. But is it really?

Bill Greenough and his successor CEOs can testify to the vitality and energy brought to the company by its independently selected trustees.

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economics/laureates/1970/samuelson-bio.html.

52. Among the Nobel Laureates was Milton Friedman. Professor Friedman served as a CREF Trustee from November 1964 to November 1968, and was a member of the Educator-Trustee Advisory Committee, a special TIAA-CREF planning and policy advisory group. Nobel Laureate, TIAA-CREF Client and Former CREF Trustee Milton Friedman Dies at 94, http://www.tiaa-cref.org/support/news/articles/Milton_Friedman.html. Professor Friedman was also a TIAA-CREF client. *Id.*

53. TIAA-CREF continues to retain its high ratings today. TIAA-CREF, TIAA-CREF Fact Sheet, http://www.tiaa-cref.org/about/press/about_us/facts.html (last visited Feb. 23, 2008).

54. *See* Anne Tergesen, *The Biggest Fund You Never Heard Of*, BUS. WK., Sept. 13, 1999, at 152 (describing how the unknown-to-the-public TIAA-CREF is the "world's largest pension system").

There might even be an upside for corporate America if it found a similar way to inject new ideas and new talent into its boards.

The thesis is simple: the new direct structure of pension plan ownership has brought a peculiar form of Peter Drucker's socialism to America,[55] and it is expressing itself in new shareholder activism. The inevitable focus of this new coalition of workers and investors will be the performance of management and the boards of directors. Inevitably, the way that directors are selected for the board will change. One can hope that the SEC will let this new selection process develop in a way that allows ingenious solutions to develop that will accommodate legitimate economic concerns of corporate leadership.

55. *See generally* DRUCKER, *supra* note 23 (suggesting that due to the influence of institutional investors, the United States fits the orthodox definition of a "socialist" system).