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ABSTRACT

This paper reports on a study that compares the views of corporate CEOs and public pension funds on two corporate governance issues: chairman - CEO duality and election of a board lead director. Questionnaires were distributed to public pensions funds, each with assets of at least one billion dollars, and to corporations selected from the Standard and Poor's 500 and Standard and Poor's midcap 400 indexes. The results indicated that CEOs did not favor either splitting the CEO and chairman positions or the election of a lead director. Pension funds also did not favor splitting the two positions but did support the election of a lead director. Possible explanations and implications are discussed.

INTRODUCTION

Historically, from the beginnings of American corporate finance, investors have sought influence within the corporations they financed. A well known and early example of investor influence is the case of General Motors. In 1920, a series of strategic and financial blunders sent General Motors' stock price tumbling. Its largest shareholder, Pierre S. Du Pont, assumed GM's presidency himself. After three years in the role, he handed control of the company to Alfred P. Sloan (Taylor 1990).

As corporations grew, one owner or a small group of owners could rarely satisfy their capital needs. Coupled with the emergence of professional managers and the dispersion of stock holdings across millions of individual investors, investors became less involved in the operations of the companies they invested in. In 1933, Adolf A. Berle and Gardiner C. Means noted that the legal owners (shareholders) had become divorced from the control of the corporations they invested in. Professional managers had assumed the traditional roles of ownership. The authors concluded that most owners own stock, insurance savings, and the like and did not manage; on the other hand, most managers did not own stock in their companies (Berle & Means 1932).

One Harvard Business School study begun in the 1940s raised questions that are still unresolved today:

> Repeatedly, we were cautioned that the board — and when executives and directors use this term they invariably mean the outside members of the board — should not be involved in what was termed 'day-to-day' management of the business, and that it should not have a disruptive interference with management. Yet whenever we tried to pin down what the speaker meant by this, the response would be something like 'Well, it's very difficult to be specific' or 'It's hard to say, it varies from company to company.' Thus, very early on we were faced with an apparent conundrum… How is it possible to have an active, effective and participating board that does not have a disruptive interference with management? (Lynch 1979).

A variation on this same question faces pension plan sponsors today — how is it possible to be active, effective, and participating long-term investors without disruptively interfering with management or corporate directors?

BACKGROUND

Peter Drucker, as well as others, has noted that pension funds, particularly *public* pension funds (pensions sponsored by government for the benefit of public sector employees), have unique characteristics differentiating them from other institutional investors. Because they are created as an act of public policy, and represent the public sector, they have closer ties to government than most corporate stakeholders. Insulated from pressures of fund investors seeking short-term performance, the public funds can actuarially predict their cash flow needs decades in advance, thus enabling them to take a long-term view. Additionally, the $100 billion asset size of some of the larger public funds makes their security holdings somewhat more illiquid than many other institutions. (Drucker, 1992).

In recent decades, as the size of their equity holdings has grown, many institutional investors have sought to assume more active roles in the governance of the corporations in which they have invested. Finding it difficult to follow "the Wall Street Rule" (which held that if investors were dissatisfied with a company's performance or practices they should sell the stock), public pension funds have tended to adopt a more active mode of share ownership. Resisting more confrontational methods, pension funds have sought to influence companies through negotiation and public statements. A fund can apply pressure to a CEO by identifying a company as structurally flawed or underperforming. Reflecting their strength, the funds find that many companies will work with them to resolve issues rather than risk public confrontation.

SPLITTING THE CEO AND CHAIRMAN POSITIONS

The separation of ownership from management and the continued growth of the capital needs of companies spawned an evolutionary change in the role of the chief executive. An increase in the size and complexity of business gave rise to the need for an increasingly sophisticated and professional manager. In short, as companies matured, their capital needs led to changes in the relationship between owners and managers. Levy notes that these changes began to be reflected through the title generally granted to a chief executive:

> Until the period between the two World Wars, today's largest corporations typically had neither a chairman nor a chief executive officer, but one person whose only title was that of president. Between 1910-1935, the title of chief executive officer was probably first granted to establish the president's increasing power in a period when that was crucial to organizational growth. Many presidents fought to establish primacy over their own senior managers. In addition, presidents often had to raise outside money to finance growth, without ceding control to financial suppliers.
>
> Following World War II, the titles of chairman and CEO were frequently combined in one person, possibly in recognition of the extremely strong position of the CEO. That remains the dominant practice in the United States today in large, public companies. What it now means to be chief executive, while still somewhat unsettled, is much clearer that what it means to be chairman, and the title of CEO connotes considerable power, while that of chairman does not (Levy 1993).

Only a small minority of corporations in the United States have installed an outside director as chairman, but the practice has long been common in Great Britain. According to Proned, a London research organization, 80 percent of U.S. public companies combine the jobs, a practice referred to as CEO duality. In Britain the reverse situation is the norm, as only 24 percent of public companies have a combined chairman and chief executive (Stevenson 1992).

Even in the 20 percent or so of U.S. firms where the position has been separated, non-governance reasons usually precipitated the separation. A Conference Board survey found that about one-quarter of the chairmen represented in the survey were not the CEOs of their firms, suggesting that the idea of a separate board chairman is not a novelty. However, this structure usually meant that although a retiring CEO had relinquished that title to his or her successor, while keeping the chairman title during the transition period until the actual time of retirement. In addition, activist shareholders of a few troubled firms pressured the incumbent CEO to relinquish that role and accept a new, diminished one as chairman only. The Conference Board report deemed these cases to be unusual (Bacon 1993).

The case for splitting the CEO and chairman positions was made by Lorsch and MacIver who argued that, when the positions were combined, the CEO exercised great power primarily because of his or her expertise in and knowledge of company matters. In addition, since the CEO determines what information directors receive, in most cases they see the company through the CEO's eyes. Also, the CEO controls the agenda and plays an important role in the selection of outside directors. All of these factors impede outside directors from fully exercising their power. Furthermore, since many outside directors are themselves CEOs, they are reluctant to criticize a fellow CEO. Consequently, directors' concerns about problems may not be communicated to one another until the problems have become so great that they threaten the survival of the company. Accordingly, Lorsch and MacIver support splitting the position of chairman and CEO. They contend that providing a leader separate from the CEO could help directors prevent a crisis and act quickly when one does arise; would give directors a strong voice in setting meeting agendas and in selecting directors; encourage more open discussions in meetings; and would underscore the board's right and obligation to govern the corporation (Lorsch & MacIver 1989).

Support for splitting the two positions has also come from various pension funds. For example, the California Public Employees' Retirement System (Calpers) proposed naming an independent chairman for the Electronic Data Systems Corporation, arguing that oversight of management was hindered by the fact that the board's chairman also served as the company's chief executive officer (Cropper 1998).

Opposition to the proposal for the chairman and CEO split comes primarily from corporate executives. For example, in its statement of opposition to a proxy proposal to split the position at Sears the company wrote, "The sponsors of the proposal do not indicate why an outside director must be chairman in order to share his or her particular advice and counsel" (Corrigan 1992).

Additionally, surveys conducted by the consulting firms Korn/Ferry and William M. Mercer show that U.S. CEOs who do not also hold the position of chairman receive lower compensation than those in a dual role (Frazee 1997; Levy 1993). It would seem logical that CEOs are unlikely to favor structural changes in the executive office that would decrease their earnings.

Compensation expert Pearl Meyer adds that the proposal would require extensive redefinition of the chairman's duties. She contends that "At many companies, the chairman's role is not just to run board meetings -- it's a functioning executive position, but an outside director serving as chairman would lack the knowledge about company operations to perform executive duties. Also, an outside chairman might come in highly disgruntled with the CEO's leadership, causing excessive bickering and infighting over control of the company leading to poorer performance" (Corrigan 1992).

Research conducted by Gideon Chitayat on Israeli companies that split the positions provides support to the opponents of a split in the chairman and CEO positions. Chitayat found that the division of labor between a chairman and the CEO varied from company to company and depended on their personalities. Nevertheless, the chairmen of the board seemed to be relatively inactive while the CEOs assumed all of the responsibilities and power necessary to manage the business. Furthermore, the majority of chairmen did not believe that their role was to serve as a check on the power of CEOs, but rather to provide them with advice and ideas. The actual role of a chairman of the board who was not also the CEO was limited in scope (Chitayat 1985).

Drawing on the information presented above, we formulated the following hypothesis:

Hypothesis 1: Public pension plans will be more in favor of splitting the CEO/chairman position than will CEOs.

ELECTION OF A LEAD DIRECTOR

Perhaps a less radical proposal to deal with CEO duality is electing a "lead director" in cases where the CEO and chairman positions continue to be held by one person. As described by Lorsch, the board would elect a lead director who would assume responsibility for setting the agenda of board meetings, and overseeing the work of board committees (Lorsch 1995).

Arguing for the lead director concept, William G. Bowen (board member of a half-dozen large enterprises) wrote:

> There is much to be said for having an authorized place within the organizational structure to which directors can go to register concerns and check impressions, especially when an organization seems to be in trouble or missing opportunities. The alternatives are not good ones: suppressed concerns, sub rosa grumbling, or the formation of informal cabals outside the regular channels. As I can attest from painful experience, the unstructured, informal approach can entail high costs. In addition to irritating people and encouraging splits in a board, it also operates slowly and is dependent on the more or less accidental emergence of a director prepared to take the lead. Counting on some spontaneously generated process to solve major problems is not sensible (Bowen 1994).

Earlier, John Smale, retired chairman of the Procter and Gamble company, and subsequently chairman of the General Motors Corporation, proposed that, "Outside board members should choose a lead director from their own ranks. This would help directors overcome a certain amount of inertia [to take action]" (Martin 1993).

General Motors' board is one of the few that have directly addressed the issue as a matter of policy. It passed and issued a 28-point document entitled, "Guidance On Significant Corporate Governance Issues," which stated that it was the policy of the board to select a director who would chair regularly scheduled meetings of outside directors; this director would take on other responsibilities which the outside directors as a whole might designate from time to time (General Motors Report 1994).

An opposing view to the election of a lead director was offered by Ram Charan, who contended that appointing a lead director can weaken corporate governance by imposing layers that inhibit direct communication between the CEO and the board and can lead to divisiveness and power struggles (Charan 1995).

As in the case of the proposal to split the CEO and chairman positions, the suggestion for the election of a lead director has proven to be a controversial one. While CEOs may find the election of a lead director more acceptable than being deprived of the chairman's title, we theorized that any meaningful erosion of power would be resisted by the CEOs. Therefore the following hypothesis was formulated:

Hypothesis 2: Public pension plans will be more favorable to the election of a lead director, in cases of CEO duality, than CEOs.

METHOD

Instruments

Two questionnaires were developed to ascertain the attitudes of two groups: public pension plans and CEOs of corporations. The questions in both instruments were identical except for minor wording differences to customize the survey for each group. The questions were of two types: a set using a five-point Likert scale ranging from “strongly agree”(5) to “strongly disagree”(1); and two open-ended questions.

The pension plan survey was then pilot tested on 10 pension plans to identify possible ambiguities and weaknesses in the questions. The survey was subsequently revised based on respondents’ comments and suggestions.

Sample

The sample consisted of two groups: public pension fund sponsors and chief executive officers of corporations. The former were the sponsors of all 118 public pension funds with assets exceeding one billion dollars that were listed in the McGraw Hill “Money Market Directory” (Money Market Directory 1995). “Sponsor” is the term used to designate the entity with ultimate administrative, legal, and fiduciary responsibility for a pension fund. Sponsors may, or may not, choose to engage advisors to assist them with investments and/or reporting responsibilities. For the CEO sample, 300 companies were randomly drawn from an alphabetical listing of 900 firms: the Standard & Poor’s (S&P) 500 index and the S&P Midcap 400. Of the 300 companies selected, 159 (53%) were drawn from the S&P 500 and 141 (47%) from the Midcap 400.

After two mailings of each of the questionnaires, usable replies were received from 68 of the 118 pension fund sponsors (a 57.6% response rate); these respondents managed 62.2% of all public pension fund assets held by the surveyed firms. Usable surveys were received from 61 corporations (a 20.3% response rate). Thirty-four of the respondents (55.7%) were from the S&P 500 and 27 (44.3%) were Midcap 400 companies. In addition to the 61 usable responses, another 18 wrote that corporate policy prohibited their participation in survey research.

RESULTS

The suggestion that companies adopt a policy of splitting the CEO and chairman positions so that they would not be held by the same person was not favored by either the CEOs or the pension funds. Table 1 shows the mean responses of the CEOs and the public pension funds (where 1 represented strong disapproval and 5 signified strong approval).

Table 1. Support for Splitting the CEO/chairman Position

	CEOs	Pension Funds
Mean	2.42	2.10
Standard Deviation	0.12242	0.11681

To test the hypotheses, we used the nonparametic Wilcoxon test because we could not assume the two populations were normally distributed. Application of the test to the responses of the two groups on the issue of CEO duality revealed that there was no significant difference between them at the .05 level. The analysis is shown in Table 2.

Table 2. Wilcoxon Test Results for Splitting the CEO/Chairman Position

Z-Statistic	Prob>|Z|	ChiSquare	Prob>ChiSq
1.68114	0.0927	2.8347	0.0923

Accordingly, Hypothesis 1, which had predicted that the pension funds would be more in favor of splitting the CEO and chairman position, was not supported.

While the two groups did not differ significantly in their levels of support for splitting the two jobs, the data do suggest that the CEOs were somewhat more accepting of the idea than we had expected from the literature. Answers to open-ended questions suggested that CEOs might be more receptive. For example, none of the pension funds mentioned CEO/chairman duality as a major policy issue either in the previous 10 years or as a likely issue over the next 10 years. On the other hand, two of the CEOs wrote that separation of the two positions had been the most significant governance policy change enacted by their corporations in the previous 10 years. A third CEO commented that the splitting of the CEO/chairman position at General Motors had made the concept a more acceptable consideration.

Turning next to the proposal to elect a lead director when chairman and CEO positions were combined, the pension funds were more receptive to the idea than were the CEOs. The mean responses of the two groups are shown in Table 3 (where 1 represented strong disapproval and 5 stood for strong approval).

Table 3. Support for Election of a Lead Director

	CEOs	Pension Funds
Mean	2.31	3.25
Standard Deviation	0.11045	0.10539

Application of the Wilcoxon test showed that the two groups differed significantly in their responses at the .01 level. The statistics from the Wilcoxon test are shown in Table 4.

Table 4. Wilcoxon Test Results for Lead Director

Z-Statistic	Prob>|Z|	ChiSquare	Prob>ChiSq
-5.65526	<.0001	32.0103	<.0001

Therefore Hypothesis 2, which had predicted that, in cases of CEO duality, CEOs would be less favorable than pension funds to the election of a lead director, was supported.

DISCUSSION AND CONCLUSION

This study found that, contrary to our expectation, the public pension funds did not favor splitting the CEO/chairman position any more strongly than did the CEOs. A possible explanation for the funds' reluctance to ending CEO duality is that the 1990s generally have been a period of rising common stock prices for U.S. corporations. It may be that, except in cases of extremely poor performance by a corporation, public pension funds (and other institutional investors) have been unwilling to seek radical changes such as an end to CEO duality. As long as the chief executive continues to function at an acceptable level and the values of investors' assets continue to rise, the funds may be content to observe the status quo.

Another possible explanation is that, in view of the divergent views which have been expressed toward CEO duality, the funds may not be convinced that ending the practice will necessarily improve corporate performance and enhance common stock values. Since the survey did not ask either the funds or the CEOs why they did or did not favor splitting the two positions, we can only speculate on the reasons for their choices.

The results did support the second hypothesis that, in cases of CEO duality, the funds would be more favorably disposed to the election of a lead director than would the CEOs. It is possible that the funds deemed the lead director concept to be a less radical approach and one more likely to be implemented than ending CEO duality. They may also have been influenced by the General Motors' action to establish a lead director for its board.

The rejection of both proposals by the CEOs is unsurprising. They would probably be unlikely to want to voluntarily surrender their power to run the corporation and to dominate the board of directors and, quite possibly, their ability to influence their own compensation.

It seems doubtful that pension funds will play a passive role in corporate governance in the future. For example, the Teachers Insurance and Annuity Association - College Retirement Equities Fund (TIAA - CREF) succeeded in replacing the entire board of Furr's/Bishop, Inc., a small company operating a chain of cafeterias, because the company had been performing poorly (Schultz & Warren 1998). Furthermore, the activism of U.S. institutional investors (including large public pension funds such as

Calpers) is now spreading to European equity markets, with challenges to corporate management there (Tagliabue 1998).

This study was conducted during a strong U.S. economy and with U.S. stock markets at record levels, yielding high returns to investors. Whether the results of the study would have been the same under conditions of a weak U.S. economy and falling stock markets is unknown. If economic conditions had been less favorable, it is possible that the pension funds would have been more inclined to favor an end to CEO duality and to favor even more strongly the election of a lead director.

Another question that might be raised is whether the attitudes of public pension funds are the same as those of other institutional investors, such as private pension funds or mutual funds. These are areas for further investigation. Also the study data were derived from a written survey asking a limited number of questions. The results could have been enhanced by additional open-ended questions and by conducting in-depth interviews with a sample of respondents. Finally, participation in the study was voluntary, thereby introducing self-selection limitations.

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