Travis Foster

If we know what's wrong with corporate governance, why hasn't it changed? Washington has become more involved, writing new regulations like the Sarbanes-Oxley Act of 2002 after the Enron and WorldCom failures and the more recent Dodd-Frank Act in response to the financial meltdown of 2008. Dodd-Frank, subtitled the "Wall Street Reform and Consumer Protection Act," is characterized on Wikipedia as "the most sweeping change to financial regulation in the United States

since the Great Depression, ... affecting almost every aspect of the nation's financial services industry." But will it really make a difference?

Rules are still being written. Law firms and compensation and accounting firms are holding webinars and seminars for their board clients. But, much like the joke about the light bulb, boards have to want to change. And many boards are working very hard to avoid it.

MAKING BOARDS BETTER

BY KAREN KANE

While shareholder activism may seem to be a prominent feature of the current era, the change in corporate ownership in the past 50 years is much more significant. In 1960, institutions owned about 20 percent of companies. "Today, ownership has shifted to the more sophisticated hands of institutions with research capabilities and fiduciary responsibilities, which should make for a powerful combination, but we have not seen the same shift in the composition of boards," observed Ralph Whitworth of Relational Investors, a San Diego-based asset management firm. "Boards are still composed of people who owe their position to the incumbent."

While this situation creates opportunities for activist investors like Whitworth and others, it speaks to a lack of corporate accountability. Robert Pozen, chairman emeritus of MFS Investment Management and a senior lecturer at Harvard Business School, says the structure and size of corporate boards has kept them from being effective. What some refer to as the "collegiality of the boardroom," Pozen calls "social loafing," where procedure and large group dynamics take precedence.

Pension funds, insurance companies and investment management firms are major market players around the world and have taken a largely passive role in corporate governance. Asset owners and asset managers could exert considerable influence on companies. Certainly, they would have a different view of the company's issues if they had a seat on its board. A recent issue of the McKinsey Quarterly urged institutions to "step up as owners" to usher in a new ownership culture for the benefit of the economy and of their clients.

the past decade. "Unlike Sarbanes-Oxley, in which boards were seen as the solution to the failures in corporate accountability, Dodd-Frank reflects the view that shareholders must be empowered to hold boards accountable," Gregory said.

"Boards require a culture change," said Fred G. Steingraber, former chairman and CEO of A.T. Kearney, the management consulting firm, and a veteran of 30 public and nonprofit boards. "Directors need to re-examine and even revise board committees and committee work and how this contributes to the observance of their 'duty of care' responsibility. It requires new skills and qualifications as well as more time and effort to better understand the companies they serve, to provide effective oversight in representing the interests of shareholders, and in holding management accountable."

Given the headlines on board inaction and the amount of new regulation, boards appear to be largely insulated both from shareholders and perhaps even the CEO. Consider that

POZEN BELIEVES THAT BOARDS WOULD BE MORE EFFECTIVE IF THEY CONSISTED OF "A SMALL GROUP OF PEOPLE WITH ENOUGH PERTINENT EXPERIENCE AND SUFFICIENT TIME TO HOLD MANAGEMENT ACCOUNTABLE."

Public battles for board seats by activist investors such as Carl Icahn and Bill Ackman draw media attention, but their efforts are mostly short-term, focused on a single issue for a year or two. There have been few long-term focused efforts by investors to improve specific companies. Private equity firms working quietly behind the scene say they have had more impact as they get board seats and help the companies change from within. Whitworth petitioned the Securities and Exchange Commission for changes in rule making in 1990 that included proxy access. Most of his suggestions were adopted in 1992, including the short slate, but proxy access was not.

Dodd-Frank, which was signed into law in July 2010, clarified that the S.E.C. has authority to implement proxy access. The next month, the S.E.C. adopted rules that allow some large shareholders to nominate directors to a company's board, but the commission has postponed the effective date of the rules until the Washington, D.C., circuit court rules on a lawsuit by the U.S. Chamber of Commerce and the Business Roundtable.

Many call proxy access the bell that has already been rung, giving investors a potent tool. According to the governance expert Holly Gregory, the Dodd-Frank bill accelerates a change already set in motion by the shareholder activism of

in a survey of 768 directors at 660 of the 2,000 largest publicly traded companies, 95 percent said they were doing an effective job. In the same survey, the CEOs said that only one director in five was effective.

The disconnect may be that CEOs and board members want different things. By nature, CEOs are ambitious Type A personalities. CEOs understand that boards are necessary, but few have the benefit of independent directors who serve as strategic sounding boards, helping them to make better, faster and wiser decisions. Such CEOs eschew more involvement, fearing that more engagement would encourage directors to meddle in day-to-day operations. At the same time, directors rate themselves as effective at board committee work, overseeing compliance with legal and regulatory oversight.

One signal about just how repugnant business leaders find the idea that shareholders might nominate directors is the fact the U.S. Chamber of Commerce made the defeat of proxy access its highest priority. The current legal challenge can be seen as a last gasp effort to stop it. Whitworth sees implementation as inevitable, but he believes it will be used sparingly, given the requirements. "In the universe of shareholders, there are very few, perhaps 230 shareholders of

Fortune 500 companies globally, that have the required holdings of 3 percent and have held it over three years. Still, it's a very important shareholder tool, reminding boards that shareholders are the ultimate owners of the company."

Boards are likely to see proxy access as a signal for self-correction by removing the obvious vulnerabilities that might attract activist shareholders, according to Whitworth. Boards are likely to make changes on their own if they have a member who has a conflict of interest with related parties, is over-boarded, has a poor attendance record or has exceeded retirement guidelines.

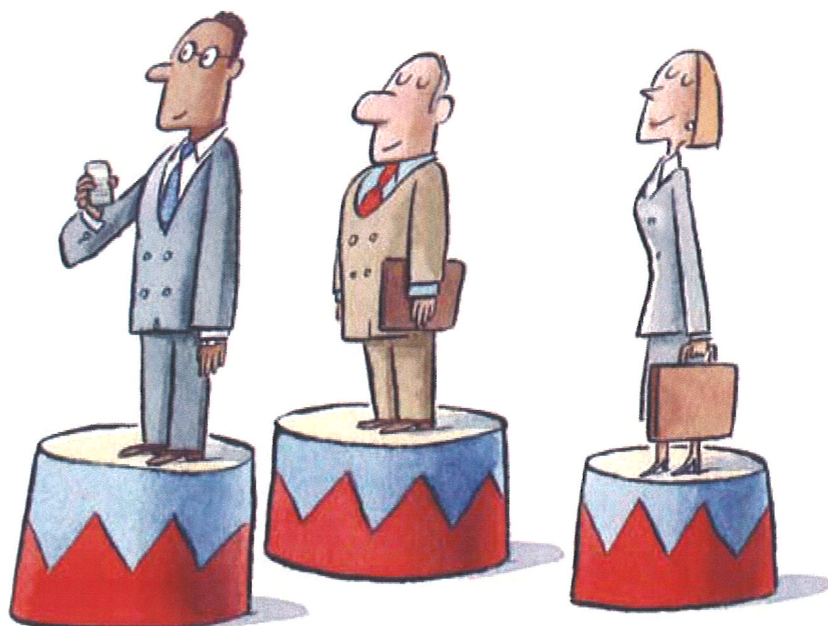
The allegation that single-issue activists would be disruptive overlooks the fact that any boardcandidate has to get majority support and, once elected, has a fiduciary responsibility to all shareholders. "If I were to one-time try to advantage my L.P.s [limited partners] at the expense of the other shareholders, I would be immediately discredited in the boardroom and by the mutual fund investors who follow me, and I would lose all good will," said Jeff Ubben, CEO and founder of ValueAct Capital, a private equity partnership that has made investments in 60 companies over the past 10 years and has taken board positions in 25 of those companies.

"Board directors aren't bad guys, but they have never written a check to participate in the company, and so there is little alignment with shareholders," Ubben said. "Most directors have stock by virtue of compensation for serving as directors. It is perhaps too much to expect them to do their own digging, to learn about the company and the industry independent of what the CEO is telling them. And it is very unusual that a director that has direct experience in the industry will be sought out by the CEO for invitation to the board."

Pozen has proposed a new board model based on his concern that most directors don't have enough relevant experience and don't spend enough time on the company's work. He believes that boards would be more effective if they consisted of "a small group of people with enough pertinent experience and sufficient time to hold management accountable." Typically, boards meet five or six times a year for a day each time, with conference calls in between, hardly enough time for directors to keep abreast of the global operations of a large company. He advocates that this smaller group of directors spend at least two days a month on company business between board meetings. If directors are going to make such a time commitment, their compensation should be doubled to about $450,000. Directors should also be restricted to serving on just two boards.

Steingraber agrees that effective board work is a bigger job. "Boards need to transform themselves into strong, highly functioning work groups whose members trust and challenge one another," he said. "Directors also need to recognize the role shareholders play: They are the owners of the company and board-shareholder engagement is an important element in keeping them invested. Most importantly, boards need to demonstrate leadership, which has been lacking, with a transparent results-orientation in the conduct of their work."

Compensation remains a hot button for most shareholders, especially when the board chairman and CEO is the same person.



Travis Foster

"Give me the U.K. model of a separate chairman and CEO," Ubben said. He acknowledges that the dual responsibility for management and its oversight is embedded in the current system and may require legislation to change it. Currently, the S.E.C. requires a board to describe its structure, explaining why it adds value. "I want an independent chairman, a second line of defense for my rights as a shareholder," Ubben said. "I want a chairman who can talk to shareholders, separate from the CEO." Those who currently carry both titles are naturally blind to the conflict. "They don't see it. How could they? Who wouldn't want to be his own boss?"

Whitworth puts it more bluntly. "Who wouldn't want to use other people's money and set their own agenda and set their own pay?" Whitworth asked.

Chairmen play an important governance role in Britain, said Piers Diacre, publisher of *IPE Magazine*, a European publication for institutional investors, and an observer of corporate governance practices. "Here, our chairmen communicate

directly with shareholders. Since the board is responsible for determining the nature and extent of the significant risks the company is willing to take, it's not unusual for the chairman to explain the company's business model as well as the formal performance evaluation of the board as a whole."

It might be well for directors to consider that governance concepts originating outside the United States have a history of moving into the American mainstream rather quickly. Consider "shareholder say on pay," which grew out of a 1999 white paper by the British cabinet minister Stephen Byers suggesting that shareholders have a more active role in overseeing companies by requiring a "nonbinding shareholder advisory vote on remuneration." In 2002, the British government adopted the Directors' Remuneration Report Regulations, which made annual pay votes mandatory. By 2004, say-on-pay spread to continental Europe as the Netherlands made it a requirement. It had moved to Norway, Sweden, Spain, Portugal, Denmark, France, Germany and Australia by 2007, when institutional investors in the United States filed shareholder proposals at 44 companies. In the financial overhaul, Dodd-Frank reconciled previous proposals by Representative Barney Frank and Senator Charles Schumer. Recently, the S.E.C. finalized the rules on say-on-pay and say-on-golden-parachutes.

Even an offhand comment can fuel regulatory flames. When the Deutsche Bank chief executive, Josef Ackermann, said he hoped that "someday" his board would be "more colorful and prettier, too," it sparked discussion about new restrictions and even quotas. Angela Merkel opposes quotas for the number of women on boards, even though Germany has the poorest track record in Europe for female representation. France passed a law this year requiring companies with more than 500 employees and more than $68 million in sales to have women in 40 percent of the supervisory board positions within six years. Spain has the same requirement. Women remain a minority in boardrooms in the United States (15 percent) and Britain, where the percentage has stagnated at 12.5 percent for three years running. Norway is often cited for its mandatory requirement that 40 percent of company directors be women. Yet it took 12 years for Norwegian companies to meet the quota, which got its biggest boost when a conservative minister of economics supported the quota in the interest of good business.

Diversity is on the minds of American directors, according to the recent annual corporate directors' survey by PricewaterhouseCoopers, which found that 45 percent of them cited difficulty in finding qualified women and nonwhites with expertise in technology. A whopping 86 percent of directors said they used their own network of contacts to recruit new board members. Given the possibility of quotas for women on United States company boards and the new rules for greater transparency in describing the competencies of board members, directors are well advised to look more broadly for board candidates or else shareholders may propose their own candidates in proxy access.

Directors are responsible for culture and compliance, for "infusing related values into their decision-making," according to a recent Rand report, but they are "hampered by a lack of training and awareness." Further, their ability to overcome this means "gathering the information they need to really understand their firms, as well as related risks, strategies and operational concerns."

Ubben complains that professional and nonshareholder directors have no sense of urgency. Most boards, he says, make decisions based on emotion or on supporting the status quo, rather than on fact-based information, since what most boards receive is dependent on the CEO or management's position. Ubben's team turns a value-analyst focus on the company, digging through filings to get information on competitors, developing a more legitimate picture of the company's current growth and its prospects, which is often quite different from what management has been presenting.

Similarly, Whitworth said, "If I didn't have my staff, I would feel overwhelmed on one of these boards." When board members like Ubben or Whitworth have questions, they find the answers, even if it means hiring consultants or using their own staff members' time. Professional directors are limited by the information that management gives them. "We gather enough independent information to challenge the CEO, and it's not a bad thing," Ubben said.

For all the tinkering that the government has done to try

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INTERESTING...

BUZZWORDS READY FOR RETIREMENT

A recent analysis of LinkedIn profiles has revealed that the most clichéd and overused buzzwords used by job-hunters are:

"Extensive Experience" - U.S., Canada, Australia

"Dynamic" - Brazil, India, Spain

"Motivated" - U.K.

"Innovative" - France, Germany, Italy, Netherlands

Source: LinkedIn

Hal Mayforth

MAKING BOARDS BETTER

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to make boards more accountable and transparent, "I'd trade it all for more shareholder directors," Whitworth said. Management and shareholders need not be adversarial. The key is to getting enough shareholder directors to break the logjam to enable other directors to see that shareholder directors can bring valuable insights to the board and to management.

"By the same token, there are a number of activist shareholders who have taken positions on how the company should proceed on some issue based on a sliver of information," Ubben said. "They don't know what they don't know. The activist shareholder could be proposing something very complex when it is a series of small, mundane adjustments that could really bring value to the company."

Still, there is much that activist shareholders can learn from shareholder directors like Whitworth and Ubben. They will not be perfect and will make mistakes, but they will help governance become more responsive to the owners. Proxy access is a governance tool that needs to be used responsibly and effectively. Nominating a director is one thing, but getting a majority of the shareholders' votes means appealing to a broad group of investors who will be able to see the candidate's dedication to good governance.

While most directors disparage the work of proxy advisory services, the response from activist investors and even asset managers is more complimentary. Charles McQuaid, chief investment officer of Columbia Wanger Asset Management, told members of the National Association of Corporate Directors (N.A.C.D) that the compilation of data by Institutional Shareholder Services Inc. is impressive, even though he and his staff make their own decisions based on reading the proxies of every company in which they make investments. Some institutional investors outsource their governance through I.S.S. and Glass Lewis, an independent governance analysis and proxy voting firm. "It's not ideal, but the proxy advisers' work is effective at creating the basis for an informed decision," Whitworth said.

In the meantime, there are too many investors who are sitting on the sidelines. They've been burned by the financial crisis. They wake up to see more accounts of massive fraud. There is a lack of confidence in the regulatory system, a lack of confidence in board governance to provide management oversight. It is a long road to restore and rebuild confidence.

Baby boomers, who pulled out of the market during the crash, are not likely to return – they are reluctant to put their reduced portfolios at risk. Anyone who invested from 1982 to 2000 bought into a boom in equities that attested to the benefit of long-term stock investing. As more Americans jumped into the stock market, they bid up the price of stocks. Stock-price increases fueled expectations of further growth, with investors expecting to earn annual rates of return of 20 or 30 percent. Until 2008.

CEOs seldom participate in the national governance debate. In more than half the cases, the CEO is also the chairman. CEOs say that they get "plenty of input" from their boards. JetBlue's former CEO, David Neeleman, said he ignored his board at his own peril. Neeleman was the founder and knew where he was taking the company. After a poor reaction to the ice storm in 2007, the board forced him out, and he realized how little he had cultivated his board because he was "too busy running the company." Chastened, Neeleman later said he should have worked more closely with his board.

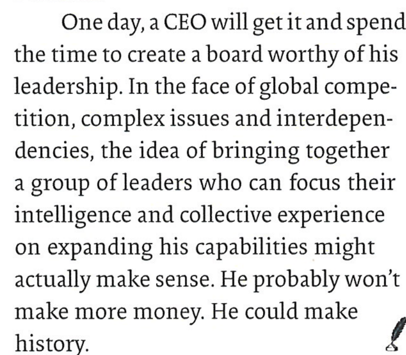
It usually takes a crisis for boards to act. Directors like being directors. It is an elite club, the cap of a great professional career. Even as they acknowledge the increased workloads, most directors are looking for another board seat. Most universities and business schools as well as the N.A.C.D. provide board training and a host of individuals – including talented women executives and capable nonwhite professionals – are attending these courses in record numbers to prepare to become board directors.

Everyone acknowledges that boardrooms are full of bright people. They want to do a good job in their role of oversight, but they may not have the right incentive for the job. They didn't write a check to participate. "If they did, it is not their primary asset," Whitworth said.

This is also not the profile of someone who will challenge the boss – the CEO-chairman. When a director asks a question during a meeting, and other directors privately confide that he or she had the same question, it is clear that this is not an effective work group.

The CEO-chairman could change all of this. He holds the levers of power. He can give the board the budget and the independence to create a small but powerful work group of dedicated advisers to help him to think through the many challenges of running a complex global business.

One day, a CEO will get it and spend the time to create a board worthy of his leadership. In the face of global competition, complex issues and interdependencies, the idea of bringing together a group of leaders who can focus their intelligence and collective experience on expanding his capabilities might actually make sense. He probably won't make more money. He could make history.



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