



▶ 25*for*25

*Observations on the
Past, Present, and Future
of Corporate Governance
In Celebration of ISS'
25th Anniversary*



An MSCI Brand



An MSCI Brand

FOREWORD	<i>iv</i>
-----------------------	-----------

INVESTOR PERSPECTIVES ON CORPORATE GOVERNANCE

These essays from three notable shareholder corporate governance pioneers explore the rise in influence of institutional investors, the cycle of corporate failures and regulatory responses, and the imperative for investors to assert their rights and utilize them constructively.

Corporate Governance: Past, Present, and Future

<i>By Robert A. G. Monks</i>	<i>1</i>
------------------------------------	----------

The Corporate Governance Movement: 25 Years Past and Hence

<i>By Ralph V. Whitworth</i>	<i>3</i>
------------------------------------	----------

The Financial Crisis, Asset Ownership, and Risk Management

<i>By Knut N. Kjaer</i>	<i>5</i>
-------------------------------	----------

SHAREHOLDER RIGHTS AND RESPONSIBILITIES

Since the U.S. Department of Labor’s “Avon Letter” directed ERISA fund managers to treat proxy voting as a fiduciary responsibility, investors worldwide have come to recognize proxy votes as an asset and a means of safeguarding their ownership interests. The articles that follow discuss institutional investors’ efforts to discharge this responsibility and the challenges they face.

The Ascendency of Corporate Governance

<i>By Michael McCauley</i>	<i>8</i>
----------------------------------	----------

Persistent Concerns in Corporate Governance

<i>By Jaap Winter</i>	<i>10</i>
-----------------------------	-----------

The Evolution of Proxy Voting Policies

<i>By John D. Phillips Jr.</i>	<i>12</i>
--------------------------------------	-----------

Asset Owners Cannot Be Passive

<i>By Rod June</i>	<i>15</i>
--------------------------	-----------

Quo Vadis Corporate Governance?

<i>By André Baladi</i>	<i>16</i>
------------------------------	-----------



An MSCI Brand

MARKET-SPECIFIC CHALLENGES

Governance concerns and regulatory responses vary from market to market. The following essays examine the United Kingdom's creative approach to regulation and areas where Japan is ripe for reform.

The Combined Code in the United Kingdom

By Lindsay Tomlinson 18

Governance Challenges in the Next Quarter Century in Japan

By Yuji Kage 19

PERSPECTIVES ON BOARD LEADERSHIP

The board of directors is the focal point of corporate governance. These articles from representatives of investors, issuers, and academia examine the evolution of boards and committees over the past 25 years and along with growing investor expectations.

The Rise of Shareholder Voice and the Increased Role of Boards

An Interview with Ken Bertsch 21

Achieving the Board of the Future, Today

By Zach Oleksiuk and Robert Zivnuska 23

The Three Elements of Effective Governance Reform

By Charles M. Elson 24

The Changes Wrought by Executive Sessions

By Ira M. Millstein and Holly J. Gregory 26

The Rise of Audit Committees

By Dennis R. Beresford 27

The Case for Independent Board Chairs

By Gary Wilson 29

Meeting the Challenges of Tomorrow Today

By Margaret M. (Peggy) Foran 31



An MSCI Brand

PERSPECTIVES ON EXECUTIVE COMPENSATION

The global financial crisis highlighted the importance of aligning the management's interests with those of shareholders. In the articles that follow, prominent governance experts examine the rise of executive compensation as a governance concern and investors' responses in the U.S. and Canada.

The Rise of Equity-Based Compensation: The Bright and The Dark <i>By Lemma W. Senbet</i>	32
Who Controls the Executive Compensation Program? <i>By Frederic W. Cook</i>	35
'Say on Pay' Arrives in Canada <i>By Stephen Griggs and Judy Cotte</i>	37

THE NEXT 25 YEARS

Our colleagues leave us with thoughts as to what the next 25 years will bring, including the need for better cooperation between issuers and investors, the role of academic research in voting decisions, the unintended consequences of regulation, and the mainstreaming of corporate social responsibility issues.

Keys to Reform Over the Next 25 Years <i>By Hye-Won Choi</i>	39
The Future of Corporate Governance and the Board of Directors <i>By Martin Lipton</i>	41
The Federalization of Corporate Governance and its Unintended Consequences <i>By Bonnie Hill</i>	44
The Past and Future of Corporate Governance Research <i>By Reena Aggarwal</i>	46
Corporate Commitment to Sustainability and CSR Reporting: An Enduring Trend <i>By Tim Smith and Carly Greenberg</i>	48
A Look Ahead at the Next 25 Years in Governance <i>An Interview with Nell Minow</i>	50



Foreword

The year was 1985, declared the “International Youth Year” by the United Nations. Careless Whisper by Wham! topped the Billboard 100 Chart, and the wildly popular video game Tetris was first released. Mikhail Gorbachev became the leader of the Soviet Union, as Ronald Reagan began his second term as U.S. president. The Dow Jones Industrial Average began the year just short of 1200 and ended around 1550, with General Motors standing near the top of the Fortune 500. Commodore introduced the first model of its revolutionary Amiga personal computer line, while Steve Jobs was fired by the board at Apple Computer.

1985 also marked the unofficial start of the modern era of corporate governance. In response to greenmail payouts, a handful of public employee pension funds banded together to form the Council of Institutional Investors. The Delaware courts decided a quartet of key cases—*Moran v. Household*, *Reylon*, *Unocal*, and *Van Gorkom*—that laid the foundation for 21st century corporate law.

Also in 1985, Robert A.G. Monks founded Institutional Shareholder Services. Bob opened ISS’ doors 25 years ago with one simple goal: to help asset owners, and by extension, asset managers, to carry out their fiduciary obligations to vote their shares in a thoughtful and informed fashion.

A quarter century later, ISS still performs its core mission by providing research, voting tools, and governance expertise to institutional shareholders. Over this same time period, however, sea changes in institutional ownership, regulation, and governance have overhauled the shareowner-director-manager engine that drives public market capitalism. To highlight our Silver Anniversary, we wanted to offer our clients a global perspective on these changes from many constituents in the governance community.

We invited 25 experts—drawn from all sides of the governance debate and from every corner of the globe—to offer their perspectives. We asked each of them one short question: “What, to you, is the most significant development in corporate governance over the last 25 years?” From their responses, we compiled the collection of essays that you are preparing to read.

As you’ll soon see, the responses are as varied and engaging as the individuals who were kind enough to offer them. Answers to the central question cover a broad range of topics—from the increasing prevalence of independent audit committees to holding executive sessions of the outside directors to the spread of advisory votes on remuneration. Market perspectives span the globe—including the United States, Canada, Japan, the U.K., and Continental Europe.

Some common threads weave throughout these 25 varied viewpoints:

- First, institutional investors have become meaningful players in the governance debate, but identifying the real shareowners has become difficult.
- Second, board members’ mandates have increased at an exponential rate and now threaten to reach overload.
- Third, enhanced corporate transparency has benefited investors, but shareholders face new challenges in handling this information avalanche.
- Fourth, executive compensation remains a contentious topic.
- Finally, communication and engagement are a necessity.

We take this final point to heart. ISS has changed its practices over the years to tap into the wealth of divergent viewpoints. Our annual policy-setting process begins with a survey of institutional investors and issuers and concludes with an open comment period. Moving far from the one-policy-fits-all approach of 1985, ISS works with our clients to develop and administer more than 400 custom policies.

The governance environment remains dynamic for issuers, investors, and for us. We look forward to being on the scene as the next era in the evolution of the public company unfolds. We are happy to have encountered so many passionate and engaged professionals along the way—including those who have generously taken their time to write for our compendium.

Enjoy.



An MSCI Brand

By Robert A. G. Monks

Corporate Governance: Past, Present, and Future

“Corporate failures have repeated themselves with almost metronomic regularity. Every decade, it seems, government predictably considers and often passes legislation: in the late ‘70s, the Foreign Corrupt Practices Act; in the ‘80s, the Corporate Democracy Act (which, in fact, did not pass); in the early years of this century, Sarbanes-Oxley; and most recently, Dodd-Frank.”

“The modern business corporation emerged as the first institutional claimant of significant unregulated power since the nation state established its title in the 16th and 17th centuries.”

—Abe Chayes

Abe Chayes, a former Kennedy administration official and long-time Harvard Law professor, wrote those words at the outset of what might be thought of as America’s own “Thirty Glorious Years”—that three-decade span from the late ‘70s through 2008 when it seemed possible that private enterprise could operate on a global stage, free from the constraints of governmental regulation and oversight. The vision was simple and stirring, and in many ways irresistible: corporate efficiency could co-exist with democracy.

Writing in 1979 in the *Stanford Law Review*, another professor, David Engel, precisely articulated the standards to which corporations would need to subscribe in order to legitimate this unregulated power within a democratic society:

- Disclose fully the impact of their operations on society;
- Obey the law;
- Restrain their impact on government—both elections and administration.

Today, we are surrounded by the wreckage of this seemingly noble experiment. “Self-restraint” proved largely to be no restraint. Rather than legitimize the power handed them, corporations have insured the ultimate need for involvement of government and the end of the dream.

There is, however, a silver lining in all this. The financial crisis of 2007–2010 has created the rare political climate in which one can realistically suggest preemptive federal action, particularly to redress the unintended consequences of earlier actions.

Corporate failures have repeated themselves with almost metronomic regularity. Every decade, it seems, government predictably considers and often passes legislation: in the late ‘70s, the Foreign Corrupt Practices Act; in the ‘80s, the Corporate

Democracy Act (which, in fact, did not pass); in the early years of this century, Sarbanes-Oxley; and most recently, Dodd-Frank.

Whatever the supposed cure-of-the-moment, the result is highly predictable: Public concern diminishes, the lobbies flourish, and the cycle starts again. Criminal malefactions dot almost every decade—General Electric and Westinghouse in the electric company conspiracies; Armand Hammer and George Steinbrenner for violation of election contribution laws; Charles Keating and the S&L crisis; Ivan Boesky and Michael Milken in the ‘80s; WorldCom and Enron in the early years of this decade; and the finance sector as a whole in the new century. Outrage invariably follows. The talking heads become screaming ones, but in the end, human nature appears to triumph over all manner of controls.

The failure of the private sector to capitalize on the opportunities afforded it over the past three decades—a polite way of describing the disgrace of corporate leadership during the *trente glorieuses*—has assured that a measure of government involvement in business will be considered politically necessary for the foreseeable future. Yet virtually everyone also agrees that role should be as limited as possible. Risk-taking, what markets best reward, is what governments do worst. Simultaneously, the Supreme Court’s *Citizens United* decision, further extending the “personhood” of corporations, all but guarantees that once recovery takes hold, the political scales will tilt even more toward corporate power. What the court grants, of course, Congress can take back with legislation limiting or excluding corporate political involvement, which could then be overturned in the courts, which could then be re-legislated on Capitol Hill *ad infinitum*. Too much is at stake to get caught on the checks-and-balances seesaw. What’s needed is a solution that approaches permanency.

If we are not to repeat this history, it leaves government with little choice in the regulation cycle, and almost certainly in ever-tighter sequences. First, the role of government as shareowner, with the rights and responsibilities attendant thereto as conferred by state law, needs to be codified. Owners of ventures expecting traditional value enhancement cannot be government bureaucrats. Second, and more important in the long term, a legal environment must be



An MSCI Brand

“For others, ownership is literally a betting slip, and it is mere coincidence that the slip relates to a share of stock, rather than a horse or a football game.”

“A further dichotomy might be drawn between those shareholders—passive and active—who choose to function as stewards and those who do not. Again, dual classes of stock might be appropriate.”

fashioned within which the fiduciaries, acting under existing laws, are both protected from peer-group unfair competition and are required by the prospect of government oversight and enforcement to be effective stewards of equity ownership.

Stiffened by such encouragement and oversight, this cadre is entirely capable of deciding how it will function as the dominant owner of publicly traded companies. The trustees are the appropriate group to determine how “activist owners” are to be compensated for the value they contribute to the over-all enterprise. They can decide the correct means by which “passive owners”—particularly those selected by formula and algorithm—can best function. Also, they can decide whether classes of stock provide a useful mode for functioning.

Having a functioning ownership class permits many difficult questions to be addressed. The most difficult of these is the power of corporations to influence and to dominate the government process by which they are regulated. The power of lobbyists appears to be enshrined by the Supreme Court with its repeated insistence on “freedom of speech”—that is to say “money”—of corporations in the law making and enforcing process. This license seriously erodes the legitimacy of corporate power.

A functioning ownership group can follow David Engel’s advice: restraint in dealing with government. The owners of a corporation can limit its lobbying and campaigning presence. Once this basic discipline is established, we can move on to the essential elements of legitimacy. How do corporations deal with the social consequences of their functioning? Again, Engel provides the answer: furnish all information to lawmakers, be respectful of the law-making process, and obey the law. Clearly, progress can and should be made in the direction of developing a more holistic accounting system, which would provide uniform requirements for taking into account “externality” costs. This is a project that the ownership cadre should address.

There can be no universal definition of “shareholder” and no possibility of articulating purpose or interest

that will apply to all components of this class at all times. This dichotomy was aptly captured 20 years ago in *The Economist* article “Proprietors or Punters.” For some shareowners, control and direction of the company in which they are invested is critical. Their objective is that portfolio companies should be sustainable; they should be able to function in harmony with civil interest indefinitely. For others, ownership is literally a betting slip, and it is mere coincidence that the slip relates to a share of stock, rather than a horse or a football game.

It may be that the passage of two decades has changed the conjunction and today the answer is Punters *and* Proprietors. It must be clear that amidst the panoply of stock ownership, there is a difference of kind between those who invest through impersonal mechanism and those whose investments are a matter of sentient choice.

A further dichotomy might be drawn between those shareholders—passive and active—who choose to function as stewards and those who do not. Again, dual classes of stock might be appropriate. It is well to remember that when Warren Buffett invests in marketable securities, he is usually able to secure a special classification that reflects the value added by his involvement. Nor has the dual class prevalent in Scandinavia lowered long-term equity returns. Even American scholars such as Martin Lipton and Jay Lorsch comment favorably on such a notion in a story in *The Wall Street Journal* in May 2010: “Providing long-term shareholders a greater number of votes per share should become a permissible option.”

Further improvement would result from the determination that stewardship, being in the interest both of the corporation and of society, is appropriately an expense of the corporation. Making a sum available for those willing to undertake the costs and exposure of stewardship would help enlist the index funds to perform this key long-term role—a vital element since what is wanted is both long-term stewardship and a perspective for the investment world as a whole, in contrast to individual companies.



An MSCI Brand



About the Author

Robert Monks is a co-founder of ISS and a long-time shareholder activist. He also was a founder of LENS Investment Management. He has written frequently on governance issues. He is the author of *Corpocracy* and *The New Global Investors*. Along with Nell Minow, he wrote *Watching the Watchers*, *Corporate Governance*, and *Power & Accountability*.

By Ralph V. Whitworth

The Corporate Governance Movement: 25 Years Past and Hence

“Constructive, behind-the-scenes persuasion will work in most cases, but successful diplomacy depends on alternatives with teeth, so shareholders must be prepared to take action when quiet encouragement fails. They must be willing to initiate vote-no campaigns or nominate replacement directors using the new proxy access rules or independent proxy initiatives.”

The last 25 years have brought sea changes in the way both investors and corporate boards approach corporate governance, but the impact on boardroom dynamics and performance is still a mile wide and an inch deep. That’s because, over the years, while there have been many changes in boardroom processes, there have been very few changes in the way we select directors. With new attitudes firmly instilled and better tools in place, investors have an enormous opportunity (and responsibility) over the coming years to improve board composition.

Beginning in the 1950s, corporate America witnessed a tectonic shift in equity ownership away from passive individual investors and sleepy trust departments into the hands of more sophisticated institutional investors. By the mid 1980s, this phenomenon gave rise to a potentially powerful new ownership regime that combined fiduciary responsibility with research capability. Despite this new breed of owner, even today incumbents continue to dominate the nomination process and whether shareholders vote “for,” “against,” or not at all, they get the same slate of directors. It’s perplexing but true that the tiger inherent in institutional ownership remains largely toothless.

That said, there have been many significant steps in the right direction. Below I describe a few, but by no means all, that come to mind from my personal experience.

In 1985 Jay Goldin, Roland Machold, and Jesse Unruh joined forces to found the now trillion-dollar-strong Council of Institutional Investors to advocate the interests of the new institutional investor. A year later, T. Boone Pickens provided the funding to found the United Shareholders Association (USA) to organize individual shareholders behind improved shareholder rights, and I became its first president (pro bono).

As Administrator of the Department of Labor’s Office of Pension and Welfare Benefit Programs, which administers the Employee Retirement Income Security Act (ERISA), Bob Monks first raised the proposition that shareholder votes should be treated as pension plan assets. Building on that concept, in 1988 the Labor Department issued its “Avon Letter” instructing ERISA

fund managers to vote proxies with the same diligence as making other fiduciary decisions. Contemporaneously, Monks and Nell Minow founded Institutional Shareholder Services to advise institutional investors on proxy voting. These giant steps laid the groundwork for change.

With governance-related shareholder proposals today routinely receiving majority votes, most observers may not realize that, as recently as 1988, a retired railway conductor, Richard Foley, with the help of USA, presented the first shareholder proposal to receive a majority vote. Not coincidentally that was the first year of “Avon Letter” enforcement.

In 1992, the SEC, chaired by Richard Breeden, promulgated the most far-reaching reforms of executive compensation disclosure and shareholder voting rules in the history of our securities laws. That action partially was in response to a petition for rulemaking, which I authored and submitted to the SEC in 1990 on behalf of USA. These reforms streamlined rules limiting shareholder communications, broke down walls in the arcane proxy solicitation process, and, for the first time, shareholders were allowed to nominate short-slates of director candidates to replace incumbents. Within a year, my partner, David Batchelder, won the first short-slate contest at Pic-n-Save Corporation.

Ultimately, the SEC rule changes gave rise to the modern activist investor which had its roots in the early activities of the California Public Employees’ Retirement System (CalPERS) and USA. In 1987, CalPERS, guided by Dale Hanson and Richard Koppes, initiated its Focus Group shareholder activism program, and the next year USA launched its similar Target 50 program. Just a few years later, Monks and Minow introduced the concept of activist investing with the formation of the Lens Fund. In 1996 CalPERS partnered with Relational Investors to pioneer the first major institutional funding of the concept.

In an unprecedented move, institutional investors forced Roger Smith out of GM in 1990, and, by 1993, similar pressure had heads rolling from the executive suites of some of America’s most storied companies. Two of these, John Akers at IBM and Paul Lago at Westinghouse, involved a one-two-punch of multiple shareholder proposals from USA



An MSCI Brand

and pressure from institutional investors led by CalPERS. That year, American Express' board also released their CEO, James Robinson, in the face of investor pressure.

Along the way, institutional investors, led by CalPERS and the California State Teachers' Retirement System, developed formal governance policies and voting guidelines. General Motors, coached by Ira Millstein, published the first formal governance guidelines from the corporate side. These steps, along with the growing influence of ISS's voting recommendations, ushered in a broad governance reform movement.

Then, at the turn of the century, came epic corporate scandals, which brought some of the most venerated and celebrated companies in corporate America to their knees. With these sobering events we learned that the progress of which we were all so proud had come to naught. Despite all the tic-the-box reforms, debilitating, overly deferential boardroom dynamics still prevailed. The smoking gun was skyrocketing CEO pay that bore little correlation to performance. A reactionary Congress came to the rescue with the Sarbanes-Oxley reform legislation, which, unfortunately, but characteristically, focused on symptoms rather than attacking the disease. Despite the proverbial "act of Congress," corporate directors were still elected by a bankrupt process dominated by incumbents, and, by and large, institutional investors continued to rubber stamp director slates.

It took the near collapse of our financial system and GM's bankruptcy before Congress, the SEC, and, yes, institutional investors would finally begin to address the root cause of failed boards. The institutional investor-led movement to separate the roles of CEO and chairman and require majority voting in director elections has dramatically accelerated since the 2008 crisis. This year, after getting the green light from Capitol Hill, the SEC, under the leadership of Mary Schapiro, promulgated new rules allowing large, long-term shareholders to use companies' official proxy materials to put forth replacement directors. This concept was originally presented in USA's rulemaking petition back in 1990.

So what happens now and over the next 25 years? Institutional investors finally have most of the tools for which they have lobbied over the last few decades, and there is a large and diverse group of highly qualified director candidates who are anxious to serve as true shareholder representatives. This puts the future squarely in the hands of institutional investors.

The financial crisis and the SEC's proxy reforms provide the ingredients for a paradigm shift in the way boards are composed, but

the status quo's most distinct characteristic is inertia. Corporate boards shouldn't be expected to change unless pushed, but they are pragmatic. With enough encouragement, boards will rid themselves of directors who are vulnerable to proxy challenges. They will begin to jettison directors with conflicts of interest, those who sit on too many boards, those with poor attendance records, those who have stood aside and allowed compensation and accounting abuses, those who have ignored retirement ages, and those who have ignored the results of shareholder proposals. In fact, it would behoove many directors to get ahead of this curve and heed the adage that, "you gotta go, before you gotta go." Pushing boards to proactively evaluate and improve their membership, however, is only half of the solution; going forward, it's just as important that shareholders assume stronger roles in setting criteria for and recommending director nominees.

Constructive, behind-the-scenes persuasion will work in most cases, but successful diplomacy depends on alternatives with teeth, so shareholders must be prepared to take action when quiet encouragement fails. They must be willing to initiate vote-no campaigns or nominate replacement directors using the new proxy access rules or independent proxy initiatives. To succeed with either approach and to accelerate the needed changes, they must also be much more willing than they have been in the past to work together, pool resources, and communicate a consistent message to boards. In Relational's experience, we have found that engagement efforts involving two or more resolute shareholders get the quickest results.

Ironically, if board composition can be significantly improved then the governance reforms shareholders have spent much of the last 25 years fighting for will largely take care of themselves. For example, when genuine shareholder representatives sit around board tables, the positions of CEO and chairman will be separated at virtually all U.S. companies, and all companies will honor majority voting. Similarly, classified board terms will become a relic of history, and large shareholders will be routinely consulted on board nominees. Executive compensation, the most stubborn issue of all, will only come under effective shareholder influence through constant vigilance and the work of new directors who feel genuine accountability to shareholders.

In short, positive change in boardroom dynamics commensurate to the sea change in ownership is finally possible, albeit highly dependent on concerted shareholder action and 25 years late to the game. But "better late than never."



About the Author

Ralph Whitworth is a founder and principal of Relational Investors, a \$6 billion private investment fund. Relational, founded in 1996, was a pioneer in what has come to be known as "activist" investing.

By Knut N. Kjaer

The Financial Crisis, Asset Ownership, and Risk Management

“We have failed as owners, and we have failed as investors by fueling a financial intermediary industry that did not deliver what the end investors in the pension plans needed.”

We are witnessing a Greek tragedy. We will probably see this play, with local variants, in many countries over the next few years. The financial crisis is not over: the second act, wherein governments present the bill to ordinary citizens, is just under way, and may prove to be much more dramatic than the first.

The play is about the functioning of the capital markets, and what happens when there is a lack of financial discipline and the absence of real checks and balances in the system. At stake is the survival of the market capitalist system. The wealth creation was privatized, the cleaning up costs are socialized. We will probably see increasing public distrust and anger during the next decade.

Investors have played a key role in this tragedy. We have failed as owners of financial institutions, but we have also failed as investors by fueling leveraged investments into alternative asset classes and complex debt instruments without understanding the underlying risks.

THE ORIGINS OF EQUITY MARKETS

Why did a small country like the Netherlands rise to a maritime superpower during in the Middle Ages? Partly because of the innovation of joint stock companies. The technique of pooling capital made it possible to make big ships. Before this financial innovation, only governments or very wealthy families could undertake such risky investments.

The innovation of joint stock companies dates back to the mid 1200s, with issuance of traded shares for firms such as the Bazacle Milling Company in France, and the Stora mining company in Sweden. The East India Company arose in England in 1600. And the Dutch East India Company issued shares on the Amsterdam stock exchange in 1602, the first company to issue stocks and bonds.

These stock owners had a joint interest, and the value of each share reflected the underlying cash flows of the companies. Creating this source of risk capital reduced the cost of borrowing.

Stock owners took higher risk than lenders. An owner has only a residual claim on the cash flow.

All other stakeholders have contracts on their rights, and the lender has collateral in the company assets. Ownership rights are the compensation for having the residual claim, and corporate governance is about protecting the rights of the shareholders, not all other stakeholders.

THE DYSFUNCTIONAL SIDE OF THE MARKETS

The establishment of equity markets was a powerful force behind the industrialization and wealth creation of Europe and has since been copied worldwide. However, we have seen the dysfunctional side—speculative bubbles and social unrest. Equity markets provide high rewards, but at high risk. Getting it right means balancing the forces of self-interest and profit on one hand and public regulation, market structure, and accountability on the other hand.

The issuance of equities was a wonderful innovation, but it presented opportunities to transfer wealth from savers to company insiders. In some emerging markets, equity issuance is an advanced, and often accepted, means of robbery. Creating a legal market structure and an equity culture can take generations.

We have seen, in all markets, two types of systematic destruction of shareholders' value: one related to the agent-principal dilemma and one related to discrimination against minority shareholders. The cost of agent dominance takes various forms, including overpaying of executives, transfer of wealth to managers from owners, and misuse of strategic opportunities. The abuse of power by majority shareholders happens through asset transfers and stripping, internal transactions, dilution via new equity issues, and nepotism. The history of building an equity culture is the story of an ongoing fight to protect the equal interest of all shareholders; it is about power and accountability.

Protecting shareholders' interest is complicated by dispersion of ownership, from personal ownership to indirect ownership, through pension funds and asset managers. When these indirect owners run large diversified portfolios, they may lack the incentive and ability to take part in the governance of each constituent company.



An MSCI Brand

Bob Monks saw this dysfunctional side of the U.S. capital market when he and Nell Minow established Institutional Shareholder Services 25 years ago. With ISS, Monks created a powerful tool for institutional investors and the individual pension plan members behind them.

Monks created a network that could empower each client with tools to cast votes efficiently, and with the research capability to provide investors with the relevant information needed to decide their position. Each new client adds positively to all the members of the network by increasing the ability to provide more comprehensive research.

ISS gave more power back to owners, but became also powerful in itself. As such, ISS aims for the highest ethical standards, has full transparency into the policy-making process, and encourages and empowers investors to form their own policies and voting decisions. Much has changed in these 25 years, and, clearly, more work remains.

THE FINANCIAL CRISIS AND A FAILURE OF OWNERSHIP

The recent financial crisis is partly about the failures of investors. We have failed as owners, and we have failed as investors by fueling a financial intermediary industry that did not deliver what the end investors in the pension plans needed. Owners failed to understand risks and did not pursue strategies at financial institutions that were in their long-term interest.

That being said, many companies were controlled by corporate insiders. Owners were not in a position to control the companies, such as having the ability to appoint directors and create real checks and balances with management. Even if owners were successful in appointing directors, we must ask if the directors would have had the competence to understand—and have an impact on—the strategy of the companies. Today’s issues are extremely complex, and difficult for directors to understand.

How to prevent another massive destruction of shareholder value in financial institutions not only raises a general question about financial market complexity and transparency, but also focuses on the moral hazard problem: if companies are too big to fail, the owners don’t have the incentive to invest time and resources to monitor and control how the management runs the companies on their behalf.

Also, of course, there is a question of how the management is compensated. With a hugely asymmetric structure, management is incentivized to take excessive risk.

THE FINANCIAL CRISIS AND A FAILURE OF INVESTORS

Many market participants took risks that were simply inappropriate. They pursued short-term gains but failed to focus on risk management. Investors fed the financial intermediary industry and were overly optimistic about the diversification effect of alternative assets and alpha capabilities of the managers. They invested in

complex and leveraged structured products without the appropriate understanding of the risks of these instruments and the risk characteristics of the total portfolio.

Financial markets are adaptive, complex, and fragile systems. We must add another dimension to the investment decision model: Integrity. Without assessing the integrity of how companies are managed, we may fail to get a sufficient understanding of future risks, not only of each investment, but also of the marketplaces.

Private equity has often provided better governance than what is normal for the public markets. It has been easy for PE firms to take listed companies private with low-cost funding. For the marketplace and investors this outcome is probably not the best one; however, moving to private markets lowers liquidity, increases transaction costs, and imposes high management fees.

“What investors can control, e.g., by the influence of board compositions, is that the management of each company acts with integrity.”

I expect we will see a trend toward more robust investment strategies by financial investors, strategies that emphasize simplicity (not investing in instruments and markets you don’t fully understand), high quality risk management (including independent assessments of prices and risk), and prudent risk taking (more closely aligned with the objectives and governance structure of the funds).

Most importantly, I see integrity as an increasingly important factor in investment decisions.

From the angle of a large endowment, pension fund, or sovereign wealth fund, when you have a long time horizon and you “own the marketplace” (with a diversified portfolio), it follows that the sustainability of the markets themselves is important for the long-term return, as embedded in the term “universal owners.” This brings integrity in as a factor for the investment return—you must consider externalities of your investments even if you do not want to engage in “politics.”

My view is that acting with integrity is not about investors entering the political scene. Issues like climate change are ultimately up to the government to resolve through regulation. But successful long-term investors anticipate such political outcomes, knowing that costly externalities eventually will be priced into the market through regulation.

What investors can control, e.g., by the influence of board compositions, is that the management of each company acts with integrity. Integrity is about being whole and complete and honoring one’s word; considering integrity as a separate dimension means that we also assess the governance structure of a company, the quality and values of the management, and alignment between the incentive system that drives the managers and the long-term value of the company. It also means that we consider how companies interact with the society and environment around them.

MORE POWER TO OWNERS

Partly as a reaction of the financial crisis, owners are now getting more power to impact both board composition and compensation structure. The next question is: Will we be able to use it?

There are many challenges related to board composition: How to assess the quality of the full team of board members, the individuals, the degree of complementary and relevant competencies, the interaction with the management, the real independence, how to find the right candidates to complement the team. We need to do more work on board best practice standards, on disclosure of how the board works, and on how the individual members work.

We have learned the hard way the importance of compensation structure. Compensation systems must create an alignment with the owners, and must be easy to communicate. They must be linked directly to the Enterprise Risk Management systems of companies, and investors must constantly ask how a given compensation structure contributes to the risk profile of the company.

As for board elections, this responsibility is even more demanding for investors. It will take more resources, but also has the potential for creating better alignment. In fact, our biggest challenge as owners now is—having obtained many of the rights we have asked for—how do we best use these rights in constructive and value creating ways? We must step up and take responsibility.

THE PURPOSE OF BUSINESS: MORE THAN SHAREHOLDER VALUE?

Let's go back to the Greek tragedy: Who are the victims? One candidate is the member of a pension plan who, having seen the value of future pensions decline because of failed investments in alternatives and complex products, now is also facing increased taxes and decreased level of public services. The pension plan member is indirectly an owner in businesses where managers have hugely enriched themselves at the expense of the pension plan as shareholder, and also at the expense of all taxpayers. What will

her reaction be when the plot is revealed? Will we see a grassroots revolt against business and markets? Will individuals become more active in holding accountable the money managers who vote on their behalf? Will we see that they get a chance to vote by themselves, so we close the circle and get back to personal ownership again? Should we empower them to do so?

A sentence in the Financial Times not long ago provoked some thought on these issues:

Why set maximising shareholder returns as the company goal when shareholders actually are absent from stewarding the companies?

“Our biggest challenge as owners now is—having obtained many of the rights we have asked for—how do we best use these rights in constructive and value creating ways?”

What is the purpose of the firm in this new reality? And is corporate governance only about protecting the interests of one of the stakeholders, the owners? I see some additions to the mantra of maximizing shareholder value:

- Manage relations with company employees, society, and the environment in a socially intelligent and sustainable way.
- Manage the complexity of the business model in a way that gives the board a real opportunity to be in charge and oversee enterprisewide risk.
- Act with integrity in all parts of the business.

If we define the mantra as maximizing shareholder value over a long term, these additions are not in conflict; they will rather serve as helpful guidance.

My friend Bob Monks wrote in his 1991 book *Power and Accountability* about restoring the balance between corporations and society and the importance of institutional investor activism.

The equity culture is a powerful driver of wealth and prosperity; the rewards are great but so are the downside risks. Getting it right is a balancing act. In short, Monks' message is, if anything, even more compelling today.



An MSCI Brand



About the Author

Knut Kjaer was until recently president of RiskMetrics Group in New York with direct responsibility for the firm's global risk management and ISS corporate governance businesses. In 1998, Kjaer became the founding chief executive officer of Norges Bank Investment Management. He now is a member of the investment committee of the Dutch fund ABP, the largest pension fund in Europe, and he is member of the International Advisory Board of China Investment Corp.

By Michael McCauley

The Ascendancy of Corporate Governance

“Today, shareowner support for many resolutions routinely surpasses the 50 percent majority threshold required for passage.”

In the 1930s, Benjamin Graham and David Dodd succinctly described the agenda for corporate governance activity by stating that shareowners should focus their attention on matters where the interest of the officer and the stockholders may be in conflict. This included questions about preserving the full integrity and value of the characteristics of ownership appurtenant to shares of common stock.

Over the last two decades, corporate governance has become increasingly embedded into the calculus of institutional investors. Although governance concerns have been present since the early 1900s, a watershed event in the development of investors’ focus on governance issues occurred in 1988 when the U.S. Department of Labor (DOL) issued its “Avon Letter.” The DOL letter provided investors with guidance for how to treat proxy voting rights alongside other retirement plan assets, placing corporate governance factors—proxy voting on shareowner proposals, company engagement, shareowner activism, and many other related investment procedures—under the same fiduciary standard as the core investment responsibility.

Subsequently, the DOL went on to provide more detailed guidance, in 1994, and then again in 2008, through various “Interpretive Bulletins,” covering stock ownership (proxy voting) rights, participation in corporate bankruptcy proceedings, and shareowner litigation. The bulletins required voting rights to be managed with the same care, skill, prudence, and diligence as any other financial asset, with an aim to protect and enhance long-term portfolio value for the exclusive benefit of pension plan participants. These communications by the DOL clearly directed plan fiduciaries to not only vote proxies in the best interest of beneficiaries, but also mandated these organizations have written proxy voting guidelines. The single regulatory development of the DOL’s guidance has had numerous long-term impacts on issuers, investors, and the overall market.

Many investors’ voting guidelines are based on rigorous empirical research, industry studies, investment surveys, and other general corporate finance literature. Many other investors base their corporate governance principles and proxy voting guidelines on their own investment views, their

practical market experiences, as well as academic and industry studies. Most institutional investors have implemented extensive procedures, integrating different areas of their investment infrastructure, whereby corporate governance and proxy voting committees deliberate on specific proxies, manage the independence and integrity of the voting process, and develop governance policies. Such proxy committees meet regularly and routinely involve senior investment staff within an investment organization. These governance groups reach consensus on voting recommendations and specific governance concerns with owned firms.

SHAREOWNER ACTIVISM

In sharp contrast to the situation in 1988, most investment organizations today devote significant time and analytical resources directed at evaluating the corporate governance at firms in which they’ve become equity owners. The default views of many investors has also shifted greatly, moving away from predominantly deferential support of a company’s management and board, to a more nuanced and comprehensive approach based on facts and the practical experiences of market participants. This evolution and expansion of the analysis of corporate governance has also occurred on a global basis, but the advancements have been unmistakable within U.S. equity markets. Virtually all investment managers in the U.S. now have established written proxy voting guidelines, including voting policies on issues likely to be presented, procedures for determining votes that are not covered or which present conflicts of interest for plan sponsor fiduciaries, procedures for ensuring that all shares held on record date are voted, and full documentation and reporting of voting decisions. Many investment member organizations, such as the Council of Institutional Investors and CFA Institute, have developed codes of best practices and investment manuals designed to educate and inform their members about corporate governance principles covering publicly traded equity securities. In addition, many countries and international bodies have developed and implemented international policies on corporate governance and proxy voting issues, promulgating guidelines recognizing that each country need not adopt a “one-size-fits-all” code of practice.



An MSCI Brand

“As shareowner activism entails concentrated costs and widely disbursed benefits, investors with large positions are the most likely investor to obtain outsized returns to justify the costs.”

GOVERNANCE IMPACTS SHARE VALUE

The level of shareowner activism in the United States has increased considerably since the mid-1980s due primarily to the involvement of public pension funds and other active institutional shareowners. Empirical studies have identified the potential to enhance value of investments as the main motive for active participation in the monitoring of corporations. Since the late 1980s, many industry and academic studies on shareowner activism and corporate governance have found that shareowner opposition has slowed the spread of takeover defenses, such as staggered boards, which have been shown to impair financial and stock price performance. As shareowner activism entails concentrated costs and widely disbursed benefits, investors with large positions are the most likely investor to obtain outsized returns to justify the costs. Also, there has been a dramatic shift away from the old “Wall Street Walk,” the term for the active decision to sell a stock rather than attempt to affect change through continued (or expanded) investment. While the Wall Street Walk hasn’t gone away within U.S. equity markets, nor should it entirely, its significance has greatly diminished through increased passive investments and a change in philosophy among many investors.

INVESTOR SUPPORT FOR SHAREHOLDER PROPOSALS

Another major change since the mid 1980s surrounds both the expansion in the new types of shareowner resolutions, and the level of investor support for those same ballot items. Today, shareowner support for many resolutions routinely surpasses the 50 percent majority threshold required for passage, which was previously unheard of for dozens of types of individual ballot proposals. Notably, several policy topics submitted via SEC Rule 14a-8 for shareowner resolution and ratification were not even present in the mid 1980s—for example, majority voting, proxy access, “say on pay,” and supermajority voting thresholds were not major issues discussed by companies or investors. Across a wide range of voting issues, from director elections to compensation plans, shareowner voting has become more analytical and geared towards value creation and increasing firm performance.



An MSCI Brand



About the Author

Michael McCauley is the senior officer for investment programs and governance at the Florida State Board of Administration.

By Jaap Winter

Persistent Concerns in Corporate Governance

“Most institutional investors either ignore the governance aspect of their equity investments or only pay formal lip-service if so pressured by regulation.”

If we step back a little from the rush of the day, we see that the governance of listed companies has been problematic since the inception of the listed company, in my backyard, in Amsterdam, in 1602. The Dutch East-Indies Company VOC was the first listed company around the world and its first 20 years were a showcase of classic governance issues. The investors invested and were not involved in the management of the company, a group of directors ran the company without any need to account for their management (accounts were drawn up for the first time after 10 years), leaving scope for misappropriation of corporate funds by the directors, which ultimately led to the precursor of the Dutch supervisory board after 19 years.

There you have the two persistent corporate governance concerns in a nutshell: the relation between investors and shareholders, or wider, capital markets and the governance of companies, and the functioning of the board. Throughout these 400 years, the governance concerns have stayed the same, but they continuously need to be addressed in different circumstances. Looking back helps to look forward. We need to focus on the changes in the circumstances that may or may not force us to address the persistent governance concerns in a different way.

The European Corporate Governance Forum has started to review the first concern. Modern corporate governance thinking and the underlying company law arrangements assume a meaningful role for shareholders in the governance of listed companies. Shareholders have been granted decision rights collectively and voting rights individually in order to influence the governance of companies. There is a growing concern that the focus of capital market and investment developments is moving in a direction that makes a meaningful role for shareholders in the governance of listed companies less and less feasible. The focus of capital market developments is very much on enhanced trading mechanisms and liquidity as the key determinant of optimal pricing and on derivatives as instruments to slice up risk and reward elements of underlying values in different combinations. Modern technology facilitates automated trading strategies that do not require human interference. Algorithms determine timing, price, quantity, and routing of orders,

dynamically monitoring market conditions across different securities and trading venues, sometimes seeking to detect trade orders of other parties gaming on the fact that every trade order presents a free trading option for other traders. Algorithms are designed to detect other trading algorithms. Traders who want to go undetected, hide, or “iceberg,” their orders in dark order pools of undisclosed trading. High frequency trading seeks to benefit from bid-asks spread and uses statistical arbitrage strategies, by holding large volumes only for milliseconds. Derivative instruments such as equity swaps and contracts for difference are used to hedge the economic risk of equity holdings. Together with securities lending they decouple ownership rights from the economic risk embodied in the shares. All these developments move the focus of the market away from the governance aspect of share ownership. The governance aspect is at best a neglected quantity in modern trading equations. New techniques even offer possibilities for manipulation, as empty voting and hidden ownership examples show us.

Modern investment practices tend in the same direction. Institutional investors have been heralded as the new guardians of proper governance for listed companies, in particular when share ownership is dispersed and no controlling shareholder takes the lead in monitoring and disciplining management (which, if they do, has its own problems as we know). But reality has not yet delivered on the governance promise of institutional investment. Most institutional investors either ignore the governance aspect of their equity investments or only pay formal lip-service if so pressured by regulation. A combination of modern investment theory (“diversify your portfolio to reduce the risk, you cannot beat the market anyway”) and perceptions of fiduciary duties of asset managers (recently defined by Bob Monks as “the duty not to perform worse than your competitors”) leads many investors and fund managers to primarily follow and replicate the market, requiring constant liquidity and short-term focus. Solvency and accounting rules applying to certain investors may give them further incentives to avoid long-term equity holdings. Long-term ownership for many institutional investors has in fact been reduced to being long in shares rather than short, that is about it. This explains why the field is open for activist investors



An MSCI Brand

“Meaningful engagement, which by definition requires more long-term ownership, at best can be achieved in relation to a very small portion of the equity portfolio held by each institutional investor. This could be stimulated and obstacles for it, for example in the rules on acting in concert and inside information, could be removed. It will only have a significant impact if a sufficient number of institutional investors will change their investment practices and start holding portfolios of equity investments for longer periods of time....”

who see opportunities for short-term profits by forcing companies into transactions that lead to immediate cash-outs for shareholders.

In the wake of the financial crisis, institutional investors are stimulated to show more stewardship of their investments by increased engagement in the governance of companies they invest in. So far the engagement of most institutional investors is limited to a compliance level, engaging because regulation more and more requires them to have voting policies and to actually vote. This type of engagement is typically directed only at the formalities of the governance of companies; the involvement in the governance of companies is often not integrated in the primary investment decision process. It leads to outsourcing of voting efforts to proxy advisers, which in fact is another form of empty voting: voting determined by parties who have no economic exposure.

While such engagement may be better than nothing, it falls short of the meaningful engagement that corporate governance thinking assumes. Such meaningful engagement, which by definition requires more long-term ownership, at best can be achieved in relation to a very small portion of the equity portfolio held by each institutional investor. This could be stimulated and obstacles for it, for example in the rules on acting in concert and inside information, could be removed. It will only have a significant impact if a sufficient number of

institutional investors will change their investment practices and start holding portfolios of equity investments for longer periods of time, not trying to follow or replicate markets for these investments. This requires a major shift in the investment paradigm. The financial crisis could be a catalyst for such paradigm shift, as it has revealed the exposure of all institutional investors to increased volatility as they all have become investors in markets rather than companies. Some investors, pension funds such as APG and PGGM, are considering moving at least part of their portfolios into a more concentrated, long-term focused portfolio. But as it goes with paradigm shifts, they are up against a wall of cynicism (“it will never work”). It takes a boldness to go against established wisdom, which is uncharacteristic for investors.

If the transformation does not happen I think we may face a fundamental choice. One option is to facilitate activism and takeovers as ultimate but pretty harsh mechanisms to discipline companies and their management. The other option is to reconsider shareholder decision-making and voting rights within companies. The current flavor across Europe is very much the latter option as the first comes with high fallout costs to society. The governance of listed companies will be worse off and institutional investors have a lot to lose if shareholder rights are to be restricted. Will they jump over their own shadow to avoid it?



An MSCI Brand



About the Author

Jaap Winter is partner at De Brauw Blackstone Westbroek in the Netherlands. His practice areas include corporate law and corporate governance. He is professor of corporate governance at the Duisenberg School of Finance in Amsterdam and professor of international company law at the University of Amsterdam. He is a member of the European Corporate Governance Forum set up by the European Commission to advise it on governance developments.

By John D. Phillips Jr.

The Evolution of Proxy Voting Policies

“We support strong investor rights that hold directors and management accountable if they fail to act in the best interests of their shareholders.”

AllianceBernstein has a long history of devoting substantial global research resources and senior investment management time to ensuring the thoughtful and timely execution of our proxy decisions. We view ourselves as shareholder advocates and take our role as fiduciaries very seriously.

Our task has grown increasingly complex over the years. Spurred by the public outcry over the accounting scandals and corporate-governance abuses of the past decade, shareholders with varying economic and political agendas are now using enhanced proxy powers to challenge a wide variety of corporate-governance issues. They are also using proxy proposals to address broader social concerns such as climate change and universal healthcare.

The proxy process has become an effective way to bring about positive change in corporate governance and practices. But even investor groups that share many of the same goals can differ widely in how they develop proxy policy and decide which proposals to be for or against. We would divide these approaches into two broad categories—“principles-based” and “rules-based.”

We adhere to a core set of principles and assess each proposal in light of those principles. Our proxy-voting litmus test will always be what we believe is best for shareholder value. We believe that authority and accountability for setting and executing corporate policies, goals, and compensation should generally rest with the board of directors and senior management. In return, we support strong investor rights that hold directors and management accountable if they fail to act in the best interests of their shareholders.

Shareholder groups that follow a rules-based approach tend to support proposals or vote based on analysis that would impose one-size-fits-all rules to control corporate actions across companies. These rule-based resolutions and voting decisions are designed to prescribe and thus diminish the authority of directors and senior management in establishing and executing corporate practices. While we research these proposals carefully and seek to engage with proponents to see what we can learn, we tend to oppose resolutions that take a broad-brush approach.

OUR APPROACH IN ACTION

Examples of AllianceBernstein’s principles-based philosophy in action can be found in our strong and early support of proposals that empower shareholders by calling for companies to adopt majority voting for directors, establish the right of shareholders to call special meetings, allow proxy access with low ownership thresholds for the purpose of electing directors, separate the role of chairman and CEO unless there is a strong lead director role, permit shareholder votes on executive death benefits, rescind supermajority voting, and require the board of directors to recover executive incentive pay upon material restatement of corporate results or fraud. We have not supported slates of directors at non-U.S. companies when there is insufficient information about them. For many years, we have voted to eliminate takeover defenses such as classified boards and poison pills. We have also voted against directors who fail to enact proposals that we favor and that are supported by a majority of shareholders.

EXECUTIVE COMPENSATION TAKES CENTER STAGE

The proxy proposals that absorb most of our time and require the greatest amount of research are executive compensation plans—both the packages presented by managements and the resolutions sponsored by shareholder groups. We have long held that management, subject of course to the approval of the board of director’s compensation committee, should, within reason, be given the latitude to determine the mix and types of compensation and benefit awards offered to their employees. Though this standard has continued to win support from most institutional shareholders in recent proxy battles, it is increasingly being challenged by proxy advisory firms and other shareholder interest groups.

Pay for performance is a key concept that underpins many recent shareholder-sponsored resolutions concerning management compensation and is particularly appealing in the wake of the recent financial-markets collapse. But while these resolutions may seem reasonable at first blush, we have found many of them overly restrictive and/or based on arbitrary rules that could harm shareholders’ interests if applied broadly.



An MSCI Brand

Table 1: Empowering Shareholders to Hold Directors and Management Accountable

Policy	Purpose	Impact	Timeline of Policy and Status
Majority Voting	Makes shareholder voting for directors truly meaningful	Resignation of directors that receive less than majority of votes	AB was early adopter. Plurality voting, which remains in place at most companies, means that a director is elected with as little as one FOR vote, even if ALL other votes are withheld
Vote against directors not implementing proposals that AB supports and pass by a majority of votes	Makes engagement with companies more effective	Powerful in combination with majority voting. More symbolic at companies with plurality voting	AB was early adopter. Voting results suggest that not all shareholders follow up by voting against or withholding votes for directors in the next year
Clawbacks	Incentive compensation is forfeited if results are materially restated	Incentive compensation is more effectively tied to performance	AB was early adopter. There are surprisingly few shareholder proposals for clawbacks
Advisory Votes on Compensation Plans	Leads to more meaningful engagement on compensation	Broad shareholder approval or disapproval	AB adopted policy at beginning of 2009 proxy season after finding that the benefits of increased engagement outweighed initial concerns that advisory votes were too broad to be meaningful
Right of shareholders to call special meetings	Empower shareholders to address sufficiently significant issues between annual meetings	Accountability of directors and management is increased	AB was early adopter with a 10% threshold. Few companies have the right for shareholders to call special meetings and thresholds are high, at 25% or more
Separate role of chairman and CEO	Provide more effective board oversight of CEO	Improved governance	AB was an early adopter. However, we do not require the Chairman to be independent and do not require separation if a sufficiently strong lead director is in place

Some proposals have sought to dictate that no incentive compensation be paid if the company’s financial performance falls below the peer group median, based on various financial metrics. For example, this issue arose in a proxy vote involving a cyclically depressed company that had become an investment in our value portfolios based on our research conclusion that management’s strategy would be successful in restoring the company’s well-below-average profitability to more normal levels over the next several years.

An essential part of our analysis in this case was to consider the broader ramifications of the proposed measure—which would have prevented management from receiving and directors from granting any incentive compensation—on the company’s ability to attract and retain executive talent. We concluded that this restriction could prove especially toxic in the early years of a turnaround when the potential for stock-price gains from low levels may be the most rewarding. We were also concerned that it would put the company at a significant competitive disadvantage compared with competitors that did not have to abide by similar incentive-compensation rules.

We have found that companies facing shareholder advisory votes on compensation tend to be much more interested in engaging with

shareholders on the specifics of their compensation plans and in addressing investor concerns. Consequently, we support the standard of requiring advisory votes every year.

“Companies facing shareholder advisory votes on compensation tend to be much more interested in engaging with shareholders on the specifics of their compensation plans and in addressing investor concerns.”

Some shareholder groups use the proxy process to try to effect changes in the ways corporations deal with social, environmental, and political issues. Our overriding concern in analyzing such proposals is their long-term effect on future earnings and, hence, shareholder value. Accordingly, we will vote against proposals that we find unduly burdensome or that result in unnecessary and excessive costs to the company with no discernable benefits to shareholders. We may abstain

from voting on social proposals that do not have a readily determinable financial impact on shareholder value.

RESEARCH UNDERPINS DECISION-MAKING

We approach our proxy-voting responsibilities with the same commitment to rigorous research that we apply in all of our investment activities. This effort has grown even more important with the increasing complexity of recent shareholder-sponsored proposals. In addition to our firm-wide policies, we have separate value and growth proxy committees, which are directly involved in the

decision-making process to ensure that our votes are guided by the investment professionals who are most familiar with the company. The chief investment officers, directors of research, research analysts across our value and growth equity platforms, and our firm’s senior lawyers participate as appropriate in researching proxy proposals, determining our votes and developing our policies. We are also mindful of our duty to avoid conflicts of interest. We have a detailed conflicts of interest policy and maintain a policy of confidential voting.

In evaluating proxy issues and determining our votes, we welcome and seek out the points of view of all parties, including management, directors, interest groups, activists, and research providers. We strive to be impartial and objective in collecting information from as many sources as possible. This process also helps us to stay current and to develop new policies as fresh issues arise and circumstances change. Our engagement with companies and interest groups continues to grow, with hundreds of meetings per year.

Table 2: AllianceBernstein Seeks Broad Engagement on Proxy Issues

Vote or Proposal	Issue	We Met With	Outcome
Approve remuneration report	Less than 80% approval in prior year’s vote	Chairman of Remuneration Committee and other directors	Revised compensation plan; lower disapproval rate at next vote
Adopt advisory vote on compensation	Received more than 50% support	Management	Urged adoption or AB would oppose directors (Adopted)
Majority Voting	Passed by more than 50% in prior year’s vote	Management	Urged adoption or AB would oppose directors (Adopted)
Election of directors	Failed acquisition and excessive risks taken	Management	AB voted against directors (Directors resigned after annual meeting)
Lower threshold to 10% to call special meetings	Passed by more than 50%	Corporate governance secretary	AB would vote against directors if not adopted (Adopted)
Universal health care	Asked company to adopt specific proposal and seek national adoption	Representatives of interest group	AB heard arguments; concluded that issue was best left to federal government



About the Author

John D. Phillips Jr. is a senior portfolio manager for Bernstein Global Value Equities and chairman of Bernstein’s Proxy Voting Committee. He joined the firm in 1994 and was a member of the U.S. Value Investment Policy Group.

By Rod June

Asset Owners Cannot Be Passive

“The bigger challenge was deciding on the scope of our corporate governance activities, particularly in light of our size and available resources.”

I was first introduced to the concept of corporate governance in 1998 as an investment officer of the Los Angeles City Employees’ Retirement System (LACERS). Over the next several years, the emphasis on corporate governance at LACERS expanded with the creation of a Corporate Governance Committee and a new slate of asset owner activities.

The decision to be an active asset owner and to participate in the corporate governance movement was relatively easy. Large asset owners such as CalPERS and CalSTRS believed that better corporate governance could add value at their portfolio companies and were already engaging in this space. The bigger challenge was deciding on the scope of our corporate governance activities, particularly in light of our size and available resources. Much of that decision ultimately rested on properly discharging fiduciary responsibility, complying with internal investment policy, and evaluating the degree of impact that we could make in the corporate community.

Naturally, the most obvious asset owner activity was to exercise the right to vote on corporate ballot measures under our internal proxy voting policy. Asset owners should avail themselves to this important shareholder right so that they can add incremental value to their company ownership.

We also engaged in shareholder advocacy activities. Thus, we sent letters that indicated our position on particular governance matters such as board leadership and independence directly to company boards and management, to the myriad of investment regulatory bodies such as the SEC, and to

the several public security exchanges. Initially, most boards were not very responsive. However, we found that sending joint letters with peer plan sponsors to these same organizations established a very powerful coalition and created persuasive leverage within the global investment community.

In my opinion, the optimal formula for asset owner engagement is not an exact science where success is measured in precise dollars and cents; rather, it is a very important means in fulfilling a plan sponsor’s fiduciary responsibility. When all is said and done, asset owner engagement ultimately benefits a plan sponsor’s members and beneficiaries. Going forward, asset owners cannot be passive; they must be more engaged and should continue to collaborate with other investors. Adding value is a challenge for management, but governance is an area where there is still potential for improvement.



An MSCI Brand



About the Author

Rod June is the chief investment officer of the State of Hawaii Employees’ Retirement System. Prior to 2008, he worked nine years as investment officer for the Los Angeles City Employees’ Retirement System.

By André Baladi

Quo Vadis Corporate Governance?

“Shouldn’t there be a single global corporate governance code, instead of the approximately 150 codes promulgated around the world?”

Where is global corporate governance heading?

It is said that one way to forecast the future is to analyze the past. Let us then start by focusing on the corporate governance developments of the last 25 years, before attempting to sketch its prospects for the next quarter century.

CORPORATE GOVERNANCE DEVELOPMENTS SINCE 1985

The foundation in 1985 of ISS by Robert (Bob) A.G. Monks, in Washington, D.C., is likely to be recorded as the birth of the global corporate governance movement. While it coincided with the foundation of both the Council of Institutional Investors and the IRRC in Washington, it preceded the interventions of Sir Adrian Cadbury on behalf of U.K. shareholders and the corporate governance board counseling of Ira Millstein at Bethlehem Steel, the Ford Foundation, General Motors, Walt Disney, etc.

I first met Bob Monks in January 1990 in Washington, at the suggestion of his Harvard University classmate Dean LeBaron and TIAA-CREF executives, as well as journalists from *Pensions & Investments* and *The Wall Street Journal*.

I was impressed by Bob’s keen interest in history, by his high ethics, and by his cosmopolitan culture. His familiarity with French authors like Albert Camus, André Malraux, and Marcel Proust amazed me, even after learning he had studied at the International School of Geneva.

His half-dozen books (two of which were co-authored with Nell Minow) foster adequate corporate governance principles. The reports of Nell Minow, assisted by the highly qualified ISS team of executives, are also outstanding. And Bob Monks’ biography by Hilary Rosenberg, *A Traitor to His Class*, is a must for anyone interested in corporate governance.

I am grateful to Bob for encouraging my global, multicultural promotion of adequate corporate governance practices (first throughout Europe and the U.S., afterward in Asia, Latin America, and the Middle East) both before and after the foundation of the International Corporate Governance Network (ICGN), which is reported to assemble

today institutional investors holding equity assets exceeding \$12 trillion.

ISS has focused on enhancing the interests of shareholders, by inciting leading U.S. pension funds (such as CalPERS, TIAA-CREF, and other CII members), as well as corporate board directors and executives, to adopt a wide range of adequate corporate governance principles. It intervened at, among others, American Express, Avon, Borden, Eastman Kodak, Exxon, Sears, Shearson Lehman Hutton, Texaco, Waste Management, and Westinghouse.

These interventions are considered to have influenced the curriculum of the ICGN and of several major organization, e.g.:

- The CII, which often invited me to cover international issues as of its April 1990 Annual Meeting in Washington.
- The various Hermes Pensions schemes in London, and Governance for Owners founded by former Hermes Focus Director Peter Butler.
- The Corporate Library, founded in Portland, Maine, by Nell Minow, with former Maine Senate President Richard Bennett as CEO.
- The Millstein Center for Corporate Governance and Performance at the Yale School of Management, which organizes major international conferences.
- The Paris-based Organisation for Economic Cooperation and Development/OECD, which published two successive editions of Corporate Governance Principles (in 1999 and 2004) and holds international conferences in Paris. It also monitors compliance with its OECD regulatory transparency standards for the Group of 20.
- The Geneva-based UNCTAD Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting/ISAR (where I contributed to develop corporate governance disclosure practices), which holds global conferences with major accounting firms.
- The Washington-based IFC-World Bank Global Corporate Governance Forum, dedicated to corporate governance reform in developing countries.



An MSCI Brand

The European corporate governance rating agencies with which I am in touch (such as Deutsche Schutzvereinigung für Wertpapierbesitz (DSW) in Germany, the Ethos Foundation in Switzerland, Pensions Investment Research Consultants/PIRC and Manifest in the U.K., and Proxinvest in France) also benefited indirectly from the ISS effect.

However, the gradual adoption of adequate corporate governance practices by major institutional investors and by a few corporations couldn't prevent the S&P 500 drop of 49 percent throughout 2000-2002, and its 39 percent drop in 2008.

Are stock market boom-and-bust cycles (like the 1609 losses of the Dutch East India Company in Amsterdam, the "Mississippi Bubble," which led to the 1720 collapse of the Banque Royale founded by John Law in France, the 1825 U.K. and 1836 U.S. panics, the 1873 Vienna stock market crash, the 1907 U.S. stock market crash, the 1929 Black Friday stock market crash, the 1987 Black Monday U.S. stock market crash, or the 2001-2004 Enron, Parmalat, WorldCom downfalls) now likely to recur every decade or so, as predicted by certain pundits?

Some experts fear that (despite the efforts of the G-20 and other regulatory endeavors) the 60 percent equities ratio of certain major pension funds risks to be reduced in favor of Treasury Bonds, and possibly even in favor of gold (+ 500 percent since 2001), other precious or rare metals, commodities, and farmland.

PROSPECTS FOR THE NEXT QUARTER CENTURY

Adequate corporate governance reforms appear to be required in the banking sector, so as to avoid repetitions of the 2007-2008 financial breakdown. The latter is alleged to have been caused mainly by schemes described by Warren Buffett as "weapons of mass destruction." In July 2010 for instance, the SEC fined Goldman Sachs a record \$500 million for incomplete information in marketing the Abacus Fund.

"Are there justifications for having so many different corporate board structures, strategic corporate objectives, voting right tenets, accounting disclosure standards, executive remuneration criteria, peer group benchmarking models, or corporate citizenship norms?"

Moreover, efforts are required regarding the democratic one-share, one-vote tenet, which is less observed throughout the European Continent than in the U.S. Ditto for the equality of all shareholders in cases of corporate mergers and acquisitions. The divestiture to Novartis of Nestlé's 75 percent stake in its Alcon pharmaceutical affiliate penalizes the owners of the remaining 25 percent stake in Alcon to the tune of \$2 billion. These mostly U.S.-based minority shareholders have recently retained law firms to claim the higher price paid by Novartis to Nestlé.

Furthermore, shouldn't there be a single global corporate governance code, instead of the approximately 150 codes promulgated around the world? Are there justifications for having so many different corporate board structures, strategic corporate objectives, voting right tenets, accounting disclosure standards, executive remuneration criteria, peer group benchmarking models, or corporate citizenship norms? The CII, the ICGN, and the OECD could contribute to the formulation of such a code (published in the six official U.N. languages), thus mirroring somewhat the achievement of the 1948 Universal Declaration of Human Rights.

Last but not least, since the foundation of modern accounting by Fra' Luca Pacioli in his *Summa de arithmetica, geometria, proportioni et proportionalità* in 1494, the world has had to cope with several accounting systems, which have now been condensed to two: the International Financial Reporting Standards (IFRS) of the International Accounting Standards Board (IASB), and the U.S. Generally Accepted Accounting Principles (GAAP) of the Financial Accounting Standards Board (FASB). I participated in two dozen sessions focused on the IFRS of the IASB at UNCTAD in Geneva, as well as a dozen FASB sessions organized by the CII in Washington over the last decade. It's difficult to foresee how close we are to a single global accounting system.

May all these issues be resolved by 2035!



An MSCI Brand



About the Author

André Baladi is the co-founder of the ICGN in Geneva, Switzerland. He is an honorary international participant of the Council of Institutional Investors, and is a member of the IFC-World Bank Global Corporate Governance Forum, the OECD Consultative Corporate Governance Group, the International Advisory Board of the NYSE-Euronext Stock Exchange, the Swiss Association of Financial Analysts, and the Advisory Team of UNCTAD's Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting.

By Lindsay Tomlinson

The Combined Code in the United Kingdom

“The systemic failures of the financial crisis have made it difficult to claim that any corporate governance system has worked well.”

The ongoing development of the U.K. Corporate Governance Code, formerly the Combined Code, has been the major event for U.K.-listed companies. The Code is also an important experiment which, if executed on effectively, should point the way for corporate governance to develop worldwide. Is it a good model for global governance? I would say, unequivocally, yes, but, to be fair, the jury is out on this one.

In all walks of life, the U.K. is strongly in favour of a principles-based approach. The view is that regulations are inflexible and will always be circumvented. If we can establish broad principles of behaviour and stick to them, results are likely to be much better.

This preference for principles, not rules, extends to the way companies are governed. Although U.K. company law comprises thousands of pages, the essence remains quite simple. Companies are run by unitary boards of directors in the best economic interests of their shareholders. In turn, the shareholders have considerable power. If a shareholder majority loses confidence in a board of directors and its activities, the shareholders can quite easily remove and replace it. This does not happen very often, but it conditions the way in which boards operate. The basic principles are therefore very straightforward and can easily be traced back to the original creation of limited liability companies.

Having established these basic principles, how then should boards of directors operate? That is where the Corporate Governance Code comes in.

The principles underpinning acceptable board structure have been elaborated in this Code, which has evolved in a number of discrete steps since its inception in 1992. Again this is all very simple. The board is to be a unitary board and the key concepts are independence and separation of powers. The intention is to create checks and balances in the power structure of the corporation. So, the posts of chairman and CEO are to be kept independent. There should be a balance of executives and non-executives on the board and the majority should be independent. Directors should not be protected by long term contracts. And “say on pay” is already a feature in the U.K.

An absolutely key feature is that the requirements of the Code are not mandatory. As part of the Listing Rules, companies listed in the U.K. are obliged to report on how they have chosen to apply the Code. However, they are free to decide not to comply with any parts of it which their respective board considers to be inappropriate in the particular circumstances of the individual company. The company merely has to explain why it has chosen not to comply with the letter of the Code. Monitoring and enforcement is

then down to the shareholders. While they don't vote on the individual elements of the Code, shareholders can enforce their views through voting on resolutions at general meetings. Obviously the key sanction is removal of a director, and, with this power, shareholders are well positioned to ensure companies are run in shareholder interests.

The structure could not be more simple. Boards of directors run companies in the best financial interests of shareholders. They report on their approach against a background of best practice recommendations set out in the Corporate Governance Code. And shareholders can influence their approach through proxy voting with real power attached to it.

Does it work? Before the financial crisis I would have felt very comfortable saying yes. Corporate governance of U.K. companies had generally been effective and was also on an improving trend. It was a U.K. success story. But the systemic failures of the financial crisis have made it difficult to claim that any corporate governance system has worked well. I would just note that the crisis uncovered many other failings, not least by governments and regulators. But corporate governance did not cover itself with glory.

Can we fix it? Yes we can. Following the crisis, the Code was reviewed, and a significant step was taken, which was to introduce a Stewardship Code laying some obligations on investors to sit alongside those laid on corporate managements by the Corporate Governance Code. Again, this Stewardship Code is principles-based and operates on a freedom with disclosure basis. This will considerably strengthen the monitoring and enforcement by shareholders of the Governance Code. It is a logical development which should reinforce the effectiveness of corporate governance in the U.K.

In conclusion, the U.K. Corporate Governance Code and the associated Stewardship Code represent best practice standards which seek to apply a principles based governance approach to a straightforward company law framework. I think it is the best model for corporate governance, and it certainly beats the alternatives. We simply have to make it work.

About the Author



Lindsay Tomlinson is the managing director of BlackRock. He joined BlackRock when it acquired Barclays Global Investors in 2009. At that time, he had had a range of senior management roles at BGI over more than 20 years.



An MSCI Brand

By Yuji Kage

Governance Challenges in the Next Quarter Century in Japan

“The introduction of ‘truly’ outside seats to the board room should bring meaningful impact to companies in changing the atmosphere of the board room, where boards used to silently endorse the CEO’s proposals.”

As is well known especially among the readers of this compendium, we have seen significant development in corporate governance in many countries over the last quarter century. In Japan, the Financial Services Agency (FSA) has taken meaningful steps in 2010 to regulate public companies, including:

- Disclosure of cross shareholding, results of voting, and executive remuneration (including disclosure of the names of all directors earning above yen 100 million —about \$1.25 million)
- Requiring the nomination of at least one “truly outside” director or statutory auditor, through Tokyo Stock Exchange guidelines.

These regulations should have a positive long-term impact on corporate management in Japan. Needless to say, the practice of cross shareholding seems to have been the major obstacle for effective corporate governance in Japan. Over the last quarter century, its rate is perceived by many corporate executives to have fallen from virtually well over 50% down to the 20-30% range, and major banks and trading companies were recently reported to significantly cut back their cross shareholdings in response to this FSA rule, and the introduction of International Financial Reporting Standards (IFRS).

The introduction of “truly” outside seats to the board room should bring meaningful impact to companies in changing the atmosphere of the board room, where boards used to silently endorse the CEO’s proposals. In fact, many directors of companies with such outside directors or auditors admit that the CEO has to answer such basic but primitive questions as “Why do you continue this unprofitable business?” to such outsiders, which are rarely asked by the inside directors.

Regarding executive remuneration, it is reported that some 290 directors received above yen 100 million as total remuneration in 2009-10, and the highest known figure is yen 890 million.

This may suggest that executive remuneration in Japan is substantially lower than its western counterpart, implying that corporate governance works much better in Japan. Needless to say, the amount of remuneration matters less; the proportion for the management among total profit should

matter. The inconvenient truth is that even smaller amounts may not necessarily be justified at many companies with poor corporate performance. For example, 6 directors of one of the major Japanese banks received more than yen 100 million, even though the bank’s market capitalization has substantially decreased over the last decade.

That said, it is not so clear that these reforms of corporate governance have contributed to the meaningful improvement of returns on investment for institutional investors globally, especially in Japan. The sad reality is that they have suffered tremendously poor investment performance for the long-term, especially over the last few years.

The key question here should be how effectively corporate governance has aligned with the investment process. The ICGN Principles on “Responsibilities of Institutional Investors,” in which I participated as one of the members of the ICGN committee, clearly describes that both should be integrated, but in reality, it seems to be a long shot.

The major reason why it is difficult to integrate corporate governance with the investment process is that there is a substantial gap between the two.

First, there is a different focus on implementation, although both share the same objective to seek better performance. As noted in the OECD Guidance, corporate governance is focused on the structure and mechanism in general to govern the company effectively, but investment professionals primarily focus on the analysis of individual companies. People may assume that good governance should lead to better performance over the long-term, but practically, it is not easy to prove this. Investment professionals sometimes use the word “long-term” as an excuse for failing to deliver sufficient results today.

Second, the necessary skill set to accomplish the two goals should be different. It should be natural for corporate governance to be the job of professional lawyers. On the other hand, the necessary skill set for investment professionals should be analytical capability of macro and micro economic issues.

Third, there are organizational barriers: the corporate governance team is positioned separately



An MSCI Brand

from the investment group in many major institutions. Sometimes, the CIO is not even in charge of governance issues. Where the CIO is in charge of both groups, governance issues do not necessarily seem high on his or her priority list, as the CIO is so busy trying to improve investment returns.

All three issues make effective dialogue and coordination between the two groups rather difficult. Buy-sell decisions on individual stocks do not usually depend on governance judgments, or at least, governance decisions are only one of a number of key factors. This seems to be natural from an investment perspective, as the future performance of individual stocks should depend on several factors including strategy, management, and R&D. Although high quality of governance is an important necessary condition to support these factors, it may not be a sufficient condition. Still, it could not be denied that investment professionals tend to undervalue the governance aspects.

On the other hand, the governance group usually makes its decisions independently from investment considerations, primarily from a legal perspective. But some measures, for example improvement of board structures, may not necessarily be effective at a specific company at least for the short-term. Some engagement by activists may not bring expected results because of possible failures of stock selection.

However, the reality both parties face is definitely sub-optimal. There should be something for both sides to reconsider. For the investment side, governance should matter. First, as noted by David Fisher of Capital Group, one of the top investment professionals in the world, governance should be the major factor in risk management. Without

sufficient governance structure and mechanisms, a company is likely to stumble sooner or later, providing significantly negative long term impact on its profitability. Second, as former ICGN Chairman Mark Anson of Oak Hills Capital pointed out in his presentation at the ICGN annual conference in Washington in 2006, the quality of governance affects the performance of each stock market through its influence on the level of equity risk premium. On a macro basis, the better the governance, the lower the risk premium, therefore the better the performance. Thus, it should be meaningful for investment professionals to think about governance issues.

For governance professionals, cooperation with investment professionals should be indispensable, as the latter have the direct impact on company management through the purchase and sale of shares. In fact, analysts and portfolio managers who own some meaningful amount of a specific company's shares for a meaningful time should be major supporters of its management, and their views should be most convincing to management. They could sell those shares when they are disappointed by management. Departing from the Wall Street Rule because of the large amount of their holdings could be too simplistic. A reconsidered Wall Street Rule together with voting and engagement by governance professionals should be effective tools to enhance market discipline.

The bottom line is, however challenging it seems to be, the integration of the governance process with the investment process, especially with the analysis of individual companies, should improve the effectiveness of each measure of corporate governance, and be a critical agenda for the CEOs and CIOs of the major institutional investors in the next quarter century.

“The major reason why it is difficult to integrate corporate governance with the investment process is that there is a substantial gap between the two.”



An MSCI Brand



About the Author

Yuji Kage is a member of the board of the Securities Analyst Association of Japan, a member of Japan Association of Corporate Executives and Japan Association of Corporate Directors, and advisory board member of several major institutions including CFA Institute of Japan.

An Interview with
Ken Bertsch

The Rise of Shareholder Voice and the Increased Role of Boards

“We have perhaps put too large an emphasis on board ‘independence’ (as imperfectly perceived from outside the boardroom) and not necessarily enough on the right forms of accountability, or on ways to promote investor understanding of boards.”

You have said that the most significant developments in governance over the last 25 years are the rise of the shareholder voice and the increased role of boards of directors. What fueled these developments and when did they become evident?

I think it’s a process that began with concerns on social responsibility issues in the 1970s. The major impetus in the 1980s was a heightened sense of vulnerability among companies to takeovers, and investors’ concerns about the way companies responded to that through, for example, poison pills, and more generally a perceived lack of attention to the views of investors. Eventually this back and forth led to increased investor focus on the board of directors.

Boards are the fulcrum for managing interest between shareholders, other stakeholders, and management, and trying to get the balance right. So I think some investor rage in the 1980s eventually converted into constructive focus on the board of directors and how to improve it. A lot of that focus was about making boards more independent and also making them more energetic, as in exercising authority in the long-term management of the company. But we have perhaps put too large an emphasis on board “independence” (as imperfectly perceived from outside the boardroom) and not necessarily enough on the right forms of accountability, or on ways to promote investor understanding of boards.

As I talk to portfolio managers and other investors, most do feel that the board is very important. Those who have been around a long time feel the board is more important than it used to be. But almost universally they feel like it’s very hard to grasp the strength and quality of a particular board. They have a hard enough time in judging management quality; the board is even harder to know and evaluate because it is collegial and mostly private. Obviously you can make judgments about the quality of board decisions after the fact (that is, after it is apparent a board made decisions that worked out poorly), but then it may be too late.

Bottom line is that boards are more important, and investors have an increased desire to hold boards accountable in meaningful ways. I think all parties are

struggling with this changing dynamic. Some investor understanding of boardroom dynamics is essential for making accountability mechanisms work.

That is one of the challenges shareholders face, since they’re not in the boardroom. How can boards assure shareholders that they are looking out for shareholders’ interests?

I think it’s about communication, a willingness to talk. It means the governance officer at the company is available to investors and reaches out to them. It will sometimes mean directors talking to investors, although that has to be managed. I think you want the directors focused on doing the job. They should be aware of shareholders and their views, but not be consumed with those communications. From my standpoint at Morgan Stanley Investment Management, I think it’s particularly important for directors to have some willingness to talk to a large shareholder when that shareholder requests a discussion.

Obviously, companies should use the proxy statement to communicate as best they can on the quality of governance. One of the best new requirements, I think, has been for companies to discuss qualifications of their board nominees, and a good number of companies are using that quite effectively and—maybe to their surprise—to communicate better the thought behind how this board is constructed, what the various skill sets are. Hopefully behind the scenes this disclosure discipline may be leading to some additional thought about whether a given board really does have the right skill sets. Being forced to describe that to the investing public actually is useful in making sure that people think through how they can describe the qualifications of the board and the balance of skills.

How do investors benefit from this? Does it provide transparency or does it put pressure on the board to ensure that they have the requisite skills?

I think it’s both: It puts some pressure on boards to make sure that they have requisite skills and can describe them, and they should be able to describe them.

How has the role of the board of directors increased? You mentioned engagement – is this



An MSCI Brand

limited to large firms? Can we expect this to extend to the mid- and small-cap issuers?

We have as many discussions with directors of smaller companies as with larger companies. The reason for that may be that we would tend to have a bigger stake in smaller companies. That said, we also get rebuffed by boards of some mid-size and smaller companies, and it is clear larger companies in general are much more geared up to have in-depth discussions with shareholders, including involving directors in some cases. Some of this is just a function of size. Aggressive outreach tends to be more characteristic of big companies that have the staff to do this, and that want to make sure their ducks are in a row. They want to hear about issues early rather than at the last minute.

Do you see the relationship between small- and mid-cap issuers and the shareholders becoming more collaborative? What obstacles, in addition to staffing, prevent a more collaborative relationship?

I think it often is collaborative. Many small and mid caps are looking to their investors to provide some insight. That's just been happening as a matter of course.

Of course, there are many examples of tension between management and public shareholders at smaller companies, and some of this is natural and to be expected. For example, when a private company goes through an IPO, many changes are involved, and the smaller group that had run the company will come under natural pressure from expectations of a wider circle of owners. There are also more issues around takeovers and defenses at smaller companies, which can be real flare points between investors and boards, and sometimes with investors who are excessively focused on short-term results. So I think there are some inevitable conflicts, but that it helps for people to talk to each other and to understand where they're coming from.

What are some of the most important skills that companies will look for in directors in the coming years?

“There has been a bit of a shift, at least in some areas, toward directors with more subject matter knowledge in the industry the company is operating in.”

I think there has been a bit of a shift, at least in some areas, toward directors with more subject matter knowledge in the industry the company is operating in. There had been so much focus on the independence and there's been a shift from that toward the view that certain industries have technical issues that require directors to ask deep questions on technical subjects. It doesn't mean they should be micromanaging, but it does mean that some of the directors need the appropriate skill background so that there is balance on the board and so that the right questions get asked.

Which industries will have greater challenges identifying and nominating highly qualified directors?

I am not sure, but perhaps finance and pharmaceuticals. There are a lot of people in finance, but the field changes rapidly, putting a premium on those currently involved, or with very recent experience, but conflicts of interest may limit their ability to serve on boards. In oil and gas exploration and production, you run into the same competitive concerns. With regard to pharmaceuticals, academia is a natural source of directors, but there is such a web of business relationships between the larger companies and nearly all relevant academic programs that some investors raise independence concerns.

Does this put additional scrutiny on the nominating committees? Will institutional investors look more closely at nominating committees?

It does put more pressure on the nominating committees to do a good job. I think institutional investors have probably focused an appropriate amount of attention on nominating committees in the United States where at least there is an expectation of independence. I think that nominating committees have had a difficult time with this. They've gone back and forth over the last decade or so in using outside search firms and then being disappointed with what they were getting, going back to word-of-mouth among board members. They probably are a little bit less receptive to word-of-mouth from their executive suite, a little more from the outside directors.



About the Author

Ken Bertsch is the CEO and president of the Society of Corporate Secretaries and Governance Professionals. Prior to assuming this position in December, he was head of corporate governance for Morgan Stanley Investment Management.

By Zach Oleksiuk and
Robert Zivnuska

Achieving the Board of the Future, Today

“Today, boards see representing shareholder interests as paramount, and shareholders are helping boards to understand shareholder concerns.”

The past 25 years have included many significant changes in the realm of corporate governance in the United States, but none is more meaningful to the rights of shareholders than the transformation of the role of directors. Fading fast are the days of CEOs populating their audit committees with old school friends and movie stars; shareholders have come to demand a higher standard of independence, commitment, and focus on shareholder concerns.

The ratio of insider to independent directors on public company boards is increasingly skewing in favor of independent directors. The last 10 years alone have revealed significant new statutory and regulatory requirements for both the independence of directors and the independent composition of key committees, such as the audit and compensation committees. These changes mirror the expectations of shareholders about the need for independent voices in the board room. Most, if not all, major institutional investors state their preference for independent board composition in their proxy voting guidelines.

This is not to imply that collegial relationships between management and boards are unimportant. Rather, the drive toward independence stems from the belief that a board composed largely of insiders may not be able to independently represent shareholder interests when directing the company’s affairs and acting as a check on management. Independent directors are best suited to protect shareholder assets from misappropriation, excessive risk taking, and management failure.

Not only are directors on boards today more likely to be independent, they are also working significantly longer hours. From 1987 to 2007, directors reported a 68 percent increase in the number of hours worked in service to the board, to approximately 16 hours per month. The fear of missing red flags signaling significant problems, especially in the wake of the spectacular corporate failures of the last decade, has driven directors to take their roles more seriously. Simultaneously, new regulations and increased shareholder scrutiny have added to the accountability of corporate boards. As a result, the days of boards simply taking their cues from management are moving behind us.

Longer hours also make it more difficult for directors to add value while sitting on a large number of boards. Serving as a director for a large number of companies can cause a director to be less focused on the companies they help guide, which impairs their value to shareholders.

About the Authors



Zach Oleksiuk is a vice president on BlackRock’s Americas Corporate Governance and Responsible Investment team.



Rob Zivnuska is director of BlackRock’s Americas Corporate Governance and Responsible Investment team.

Recognizing this, shareholders have withheld their support for directors they deem “over-boarded.” This shareholder concern has been internalized by companies — from 2001-2006 there was a 170 percent increase in the number of companies that limit outside board service by their CEO.

Although there is no generally accepted standard for the number of companies a director can usefully oversee, most investors agree that shareholders benefit when directors focus their efforts on a small number of issuers. A narrow focus can best position a director to skillfully envision and steer corporate strategy, identify management failures or potential abuse, and nurture the growth of shareholders’ investments.

Today, boards see representing shareholder interests as paramount, and shareholders are helping boards to understand shareholder concerns. For issues ranging from executive compensation to risk management to independent leadership within the board room, shareholders have used multiple tools to encourage directors to address shareholder priorities. Techniques leveraged by shareholders include: engaging with directors directly on company-specific corporate governance issues; working with regulators and legislators to establish new disclosure requirements; using shareholder votes to hold directors accountable for effectively representing shareholders’ interests in the board room; and submitting shareholder proposals to enact certain corporate governance reforms. These varied methods serve to reveal to directors the key concerns of shareholders, thus empowering independent directors by providing them with evidence of shareholders’ desire for increased independence, and independent leadership, in the board room. A striking example of successful engagement between shareholders and their boards is the evolution of board leadership in the United States. In 2009, 95 percent of boards for S&P 500 companies reported having an independent lead or presiding director; this role was not even measured in 1999.

Shareholders today are not willing to settle for directors who are reluctant to scrutinize or unable to guide management teams toward strategies that create value for investors. They expect to be represented by focused, independent, and effective directors. Much to the benefit of public company shareholders, this expectation is well on its way to being met. Shareholder action over the last 25 years has brought U.S. investors the board of the future, today.



An MSCI Brand

By Charles M. Elson

The Three Elements of Effective Governance Reform

“To fulfill their oversight responsibilities effectively, directors must be independent of management and must hold a personally meaningful equity stake in the enterprise.”

In my view, the most meaningful and significant change in corporate governance in the past 25 years, with important implications for the future of the field, involves board composition. The board originated as a mechanism for monitoring management. Unfortunately, due to compositional changes, boards evolved into management-dominated, advisory-type panels which were unable to effectively monitor the group that they were created to watch. When I first entered the field, this was an issue at most U.S. companies. Much of my work in academe and as a board participant, and much of the thrust of the modern governance movement, has been to rekindle that historical managerial oversight role through compositional reform. The starting point for this is quite simple and can be reduced to three straight-forward elements: independence, equity ownership, and a viable election process.

The first two concepts, independence and equity, are central to active monitoring. To fulfill their oversight responsibilities effectively, directors must be independent of management and must hold a personally meaningful equity stake in the enterprise. Independence involves the absence of any economic ties, either to management or to the company itself, other than equity ownership. It provides a director with the distance and objectivity necessary to examine management action in the most productive manner. Economic relationships with management, including consulting, service provision, or other indirect arrangements, may cloud a director’s judgment and make it more difficult for him/her to review management conduct objectively. A lack of independence can lead to ineffective monitoring if, for example, it makes a director too comfortable with management and its representations or places him/her in such a close relationship with management that s/he cannot effectively disengage him/herself in order to review management conduct objectively. Keeping directors distanced from company management allows them to conduct the reflective review of management practices that public shareholders expect and that is necessary to long-term corporate success.

Coincident and complementary to its emphasis on director independence, modern corporate governance theory also stresses the need for directors to hold an equity stake in the corporation. While

director independence promotes objectivity, the requirement that board members maintain equity ownership in the corporation gives the directors an incentive to exercise their objectivity with diligence. When management appoints the board of directors, and these directors have no stake in the corporate enterprise other than their board seats, the directors simply have no pecuniary incentive to actively monitor management. When directors shirk their duty to monitor management, stockholder interests are left unprotected. The most effective incentive for directors to address their responsibilities to the shareholders is to make them significant stockholders as well. By becoming equity holders, the outside directors assume a personal stake in the success or failure of the enterprise.

It is important to note that while equity ownership provides the incentive to monitor, it alone does not provide the proper objectivity to foster effective oversight. Independence creates this objectivity, and that is why modern governance theory demands both equity ownership and independence. Independent directors without equity ownership may be objective, but they have little incentive to engage in active oversight. Equity ownership provides the incentive to exercise objective oversight. On the other hand, equity-holding directors who are not independent may have the proper incentive but lack the necessary objectivity. In fact, it was a lack of real board independence that characterized most of the companies that were implicated in the financial scandals and meltdown of the past decade. Independence and equity ownership, acting in tandem, are the keys to effective corporate governance. Judicial, regulatory, and investor pressure has made these two elements of governance reform a reality in most U.S. public companies.

The third reform element—a vibrant board election process – is also critical in its effect on the board conduct, but is still in an early stage of adoption. For much too long, people have viewed their board seats as sinecures—to be occupied as long as they choose to remain in office. This does not create the necessary sensitivity and accountability to shareholder interests that must define a truly effective board member. As management must feel accountable to the board, so must the board be accountable to the group that elects them – the shareholders. While much has been done in the past 25 years to



An MSCI Brand

create independent, equity-holding boards, the drive to open up the board election process is a relatively new one – but of equal importance to effective board governance.

Unfortunately, for a variety of reasons, in most public companies the shareholder election process functions as a mere formality to ratify the actions of a generally self-perpetuating board and management. For the election to serve as the appropriate accountability vehicle, it is important that, from time to time, there is the real potential that it function as a true contest over corporate policy and direction. To accomplish this, we need to level the playing field a bit between the incumbent board and the shareholders in the electoral process.

Traditionally in a proxy contest, the expenses of the challenging party are solely borne by that party, while the board uses the corporate treasury to finance the presentation of its position. This has been an obvious impediment to fostering vibrant elections, as all shareholders effectively subsidize the board's candidacy while the challenger is forced to personally bear the cost of a campaign. If the challenge involves a legitimate debate on corporate direction and policy, there is no good reason why shareholders of the corporation should fund the cost of promoting one view-point and not the other. This asymmetry is certainly problematic in that it acts to stifle thoughtful discussion and re-examination of corporate policy, which ultimately leads to lessened accountability by the incumbent board and management to shareholders. That is why reform is necessary, and explains the current controversy over proxy access.

While giving shareholders access to the company's proxy for director nominees has some visceral appeal, it really does not address

“While giving shareholders access to the company's proxy for director nominees has some visceral appeal, it really does not address the biggest impediment to a vibrant contest, the funds required to mount a real challenge.”

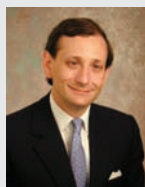
the biggest impediment to a vibrant contest, the funds required to mount a real challenge. The simplest solution to this problem is to provide some sort of reimbursement of reasonable expenses to challengers in non-control directorial election challenges. If one is successful in proposing and electing a director, then one's expenses should be reimbursed by the corporation. If an individual is unsuccessful, but loses only by a small percentage, then it is clear that the effort was over a legitimate issue and some portion of that individual's expenses should be reimbursed. Should the challenging candidate or candidates lose by a significant vote, then no corporate funds should be expended for the support of the effort.

Delaware law now provides establishment for such a regime upon an appropriate shareholder or board vote. By removing an important financial impediment to more vibrant corporate elections, the election process would no longer be a simple formality but a real forum for informed debate and ultimate expression of shareholder will. This would accomplish an important goal. The election itself, or merely the threat of a contested election, would encourage better directorial and managerial accountability to shareholders and ultimately more effective corporate performance. This approach will prove ultimately much more effective than the final proxy access rule adopted by the SEC (which among other problems, unfortunately, does not include small shareholders in its reach).

Board independence, equity-ownership, and vibrant elections are the three elements that have defined real governance change in the past 25 years. They are, in my view, the key to the future of the field and, ultimately, real investor protection, and more successful corporations.



An MSCI Brand



About the Author

Charles Elson is the Edgar S. Woolard Jr. chair in corporate governance and director of the John L. Weinberg Center for Corporate Governance in the Alfred Lerner College of Business & Economics at the University of Delaware.

By Ira M. Millstein and
Holly J. Gregory

“This single practice of directors meeting without the CEO or other members of management present on a regular basis is directly responsible for the palpable change in boardroom culture.”

The Changes Wrought by Executive Sessions

Over the past 25 years, the board culture of U.S. publicly-traded companies has changed dramatically; the board-created practice of holding regular executive sessions outside the presence of management has been the primary device shaping this culture shift.

Beginning in the early 1990s and accelerating throughout the decade, leading boards instituted the practice of holding “executive sessions,” which, counter to what the term implies, are sessions of the outside directors without corporate executives present. This best practice was born from the practical experience of seasoned directors seeking to create an independent culture, not from any regulatory or shareholder mandate. Executive sessions were first formalized in the GM board’s principles of corporate governance in the early 1990s, and then quickly adopted voluntarily by a number of prominent boards. After a decade of voluntary experimentation and experience, the scandals of 2001 and 2002 led both NASDAQ and the New York Stock Exchange to impose, as a condition of listing, a requirement that boards hold regular executive sessions of non-management and independent directors. As a result, it is now commonplace for outside and independent directors to meet regularly without management present—often at the end of every board meeting.

Generally, the board chooses a non-executive chairman or an appropriately empowered lead director to convene and lead the executive session. Many boards schedule time for an executive session, even if for only 10 or 15 minutes, as a matter of course, at every meeting. This regularity fosters comfort with the process by directors and managers alike. Agendas for executive sessions tend to be fairly open-ended. It is not unusual for the directors to convene in executive session without any planned agenda, simply as an opportunity to talk about anything that is on their minds. Common topics include issues related to the management and corporate performance, key strategic proposals, and the evaluation, compensation, and credibility of the CEO and other key members of the management team. Executive sessions also provide the opportunity to

discuss specific items raised in the board session. Minutes of these sessions can be critically important in showing down the road that the outside directors acted with care and in good faith.

At the end of an executive session, the directors typically agree on what feedback should be given to the CEO. Often, the leader of the session will meet with the CEO to talk generally about topics that were discussed and to provide a more specific message as appropriate. Just as with the holding of executive sessions, the regular practice of following up with the CEO as a matter of course helps shift culture and expectations, so that regular feedback comes to be viewed as constructive for both the board and the CEO.

This single practice of directors meeting without the CEO or other members of management present on a regular basis is directly responsible for the palpable change in boardroom culture since the days a quarter century ago when boards often earned the description of “parsley on the fish.” What has emerged is a culture of board accountability, independent-mindedness, and willingness to take hard action when necessary. This culture reflects a change in awareness about what is expected of directors.

By providing an opportunity for directors to share their assessments of management integrity and performance, strategic direction, succession planning, or anything else on their minds, executive sessions encourage candor, frank discussion, and, when necessary, action about issues that may be difficult to discuss with management members in the room. Executive sessions often also generate ideas for enhancements or improvements in board process. Based on the many opportunities we have had to observe boards in action, and from our participation in numerous discussions in peer group sessions among directors and advisors, it is readily apparent to us that executive sessions are indispensable and an essential board practice. They were invented by boards to foster independent thinking and action; they have proven successful, and, as a result, are highly valued by directors.

About the Authors



Ira M. Millstein is a senior partner at the international law firm of Weil, Gotshal & Manges, where, in addition to practicing in the areas of government regulation and antitrust law, he counsels boards of directors on corporate governance matters. He also is the senior associate dean for corporate governance, and a visiting professor in competitive enterprise and strategy at the Yale School of Management.



Holly J. Gregory is a partner in the international law firm of Weil, Gotshal & Manges, where she counsels corporate boards on the full range of corporate governance issues, ranging from adoption of best practices to board investigations to relations with shareholders.



An MSCI Brand

By Dennis R. Beresford

The Rise of Audit Committees

“It can be argued that the rise in importance and substance of audit committees has led the way for increased corporate governance in most other aspects of board activity.”

As a senior manager in the Los Angeles office of Ernst & Ernst in 1971, I was asked to meet with the chairman of the audit committee of one of my firm’s largest clients. This was a big surprise as: (a) I didn’t know the client had an audit committee; and (b) I didn’t know what an audit committee was! It turned out that the chairman of the committee was almost as uninformed as I. He’d recently been given that responsibility and just wanted me to review the company’s financial statements with him so he wouldn’t look too unprepared when he had to meet with the CEO and CFO to go over his new duties.

Audit committees, of course, have come a long way since then. In fact, it can be argued that the rise in importance and substance of audit committees has led the way for increased corporate governance in most other aspects of board activity. If nothing else, it has been commonly agreed for the past decade or so that those directors serving on audit committees are likely to spend more time on their board duties than other directors.

Going back to the time of my 1971 meeting, there was no requirement then for public companies to have audit committees, although the New York Stock Exchange had endorsed the concept all the way back in 1939. In 1972 the SEC recommended that registrants appoint audit committees comprised of outside directors. But a requirement followed not too long after, at least for NYSE-listed companies, in the form of a 1977 listing requirement for audit committees with entirely independent directors. NASDAQ listed companies became subject to a similar requirement in 1987.

Throughout the late 1970s, 80s, and into the 90s, audit committees thus became more of a standard practice for public companies. However, there remained very little consistency in what those committees actually did. In the late 1970s, the SEC Practice Section of the American Institute of CPAs issued guidance to auditors of public companies on communications with audit committees that improved committee oversight of external audit. However, in other respects there remained relatively little consistency in what those committees actually did.

Individual accounting firms, law firms, and others

published suggestions on things such as: audit committee charters; suggested annual work plans; questions that committee members could ask of management or external auditors at committee meetings; and many other matters. Most of those suggestions were described as “best practices” and few, if any, emerged as requirements over that period.

During this period, active audit committees might meet several times a year for a few hours each time. The new committees being appointed per the NYSE and NASDAQ listing requirements might meet only three or four times a year – often for an hour or less the morning or the afternoon of a regular board of directors meeting. Clearly, the work of those latter committees, while adhering to the letter of the listing requirement, was often not of much substance.

Over time, the NYSE and NASDAQ listing requirements were supplemented through specific procedures the audit committees were expected to perform. Much of this came in the very late 1990s and early 2000s, more specifically as a result of rule changes based on the Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of the Corporate Audit Committee. That Committee had been appointed by SEC Chairman Arthur Levitt as a result of earlier financial reporting and auditing problems.

Even with the requirements for audit committees and rules for specific procedures, too many of those committees still were not taking their responsibilities as seriously as they should. Then came Enron and WorldCom in 2001. A subsequent report by a Special Committee investigating the WorldCom matter noted that the audit committee, “... met between three and five times per year between 1999 and 2001. Meetings lasted about one hour except that the February 2002 meeting, likely in response to heightened awareness growing out of the Enron scandal, lasted closer to two hours. We believe that the Board – and in particular the Audit Committee – played so limited a role in the oversight of WorldCom that it is unlikely that any but the most flagrant and open financial fraud *could* have come to their attention.”

Of course, Enron and WorldCom begat the Sarbanes-Oxley Act of 2002. This put real teeth into the audit committee function. Both the need for and



An MSCI Brand

“Many of the ways in which corporate governance in general has been influenced so dramatically in the past couple of decades had their antecedents at the audit committee.”

the specific duties of an audit committee were now the subject of federal securities law although many of the specifics emerged through subsequent SEC regulations.

Audit committee composition also is now regulated with all members expected to be able to read and understand financial statements. Further, in general, at least one member should be an “audit committee financial expert,” which effectively means he or she should be quite conversant with generally accepted accounting principles and other audit committee responsibilities. These requirements have caused boards to recruit more directors with financial backgrounds to fill audit committee positions in recent years.

Adding to the audit committee’s governance effectiveness is the Sarbanes-Oxley requirement that CEO’s and CFO’s now must personally certify and personally sign the quarterly and annual financial statements as well as the internal controls over those financial reports. This probably was always implicit but SOX makes it explicit. Of course, this is supplemented by an active disclosure committee at most public companies these days.

While the large majority of audit committee activities still relate to accounting and auditing matters, today’s committees also are quite often involved in overseeing risk management. To date, only about 10 percent of larger companies have formed a board risk committee (with much lesser numbers

for smaller companies). Of the remainder, most assign risk oversight to the audit committee as per NYSE listing requirements, although some now reserve that responsibility for the full board. Risk management can run the gamut from financial risks such as cash flow and access to capital, to operational risks and even such strategic risks as the company’s reputation.

To summarize, many of the ways in which corporate governance in general has been influenced so dramatically in the past couple of decades had their antecedents at the audit committee. Pressure for more outside and then fully independent directors certainly came from this first being part of audit committee recommendations and then requirements. Likewise, having much of the work of the board being done at the committee level rather than by the board as a whole occurred more frequently first with the audit committee. In today’s world it is not uncommon for a day of committee meetings to last longer and cover more than the subsequent full board meeting!

Finally, the extensive interaction between board members and corporate executives beneath the level of the CEO and his/her direct reports may have happened more frequently and earlier at the audit committee than other areas of corporate governance. As some directors have said, if you are new to a board, be sure to join the audit committee as that’s where you will learn the most about the company!



An MSCI Brand



About the Author

Dennis Beresford is the Ernst & Young executive professor of accounting at the J. M. Tull School of Accounting at the University of Georgia’s Terry College of Business. He serves on the board of directors of the National Association of Corporate Directors and is a member of the Public Company Accounting Oversight Board’s Standing Advisory Group.

By Gary Wilson

The Case for Independent Board Chairs

“With today’s higher standards of corporate governance, why do we still have Imperial CEOs? And what can be done about it?”

America’s most serious corporate governance problem is the Imperial CEO—a leader who is both chairman of the company’s board of directors as well as its chief executive officer. Such a CEO can dominate his board and is accountable to no one.

This arrangement creates a conflict of interest, because the chairman is responsible for leading an independent board of directors. The board’s primary responsibility, on behalf of the owners, is to hire, oversee and, if necessary, fire the CEO. If the CEO is also the chairman, then he leads a board that is responsible for evaluating, compensating and potentially firing himself.

The result of this conflict of interest is excessive CEO compensation and undeserved job security. Entrenched management leads to empire-building, continued adherence to flawed business strategies, resistance to change, the stifling of healthy debate in the boardroom, and destruction of shareholder value. Failures of board leadership and oversight were a common threat at banks at the center of the financial crisis. It is no coincidence that many of these were headed by a combined chairman and CEO.

With today’s higher standards of corporate governance, why do we still have Imperial CEOs? And what can be done about it?

Imperial CEOs are a legacy of an era when directors were appointed by the CEO and provided minimal oversight over his leadership. Notwithstanding the increased role of nominating committees in the current environment, most directors—even those who are technically independent—have varying degrees of independence.

I believe the simple step of separating the positions of chairman and CEO would resolve this pernicious corporate governance problem. It would rein in the Imperial CEO and shift power to an independent board, acting as it should in the interest of shareholders, not the CEO.

Today, despite growing shareholder opposition, the CEO and the chairman remain the same person in 65 percent of the S&P 500 companies. Surprisingly, such blue chip companies as General Electric, Exxon Mobil, UPS, Deere, Caterpillar, CSX,

and Johnson & Johnson actually have bylaws that require the CEO to also serve as chairman.

Many European countries require that the chairman and CEO positions be held by different people. And not surprisingly, European CEOs generally receive less compensation and lavish perks than American CEOs. While the gap is narrowing, several recent studies have shown that U.S. CEOs of major companies tend to get paid on average two or three times what their European counterparts receive. There is no evidence that the American CEOs perform any better for shareholders. By requiring separate management and supervisory boards, Europe has shifted the power balance to the board and owners, and away from management, and it appears that the owners are getting more bang for their euro in executive compensation.

Imperial CEOs are not likely to willingly relinquish power and directors have little incentive to challenge the status quo. In addition, shareholder proposals requesting separation of the chairman and CEO positions encounter strong opposition from mutual funds, which are often led by an individual who holds the positions of chairman and CEO. However, separating the roles of chairman and CEO can be accomplished somewhat painlessly. I suggest that stock exchanges and the proxy advisory firms require that when a company names a new CEO, it must also name an “independent director” as chairman. CEOs, by definition, are not independent directors, so this would effectively separate the two positions.

Proxy advisory firms such as ISS have become very influential with institutional investors. They focus on corporate governance issues and recommend whether their investor clients should withhold votes from a company’s proposed board nominees. These firms recommend separating the CEO and chairman roles, but do not require it in order to support the proposed slate of directors. Instead, they allow for a “lead director” who is supposed to help the chairman/CEO with the board agenda and preside over meetings of independent directors without management present.

I have served on the boards of three major American corporations that evolved from chairman/CEO, to chairman/CEO plus lead director, to



An MSCI Brand

“The chairman/CEO plus lead director model is actually worse than the chairman/CEO model, because investors falsely believe the lead director has the power to protect their interests.”

separating chairman and CEO. In my experience, the chairman/CEO plus lead director model is actually worse than the chairman/CEO model, because investors falsely believe the lead director has the power to protect their interests. In fact, the lead director has little practical power and is frequently selected by the chairman/CEO. In America, he who sits at the head of the table runs the meeting.

I saw this tension firsthand on the board of Disney. A dominating long-time CEO, Michael Eisner, who was also chairman, had led the company very effectively for many years. However, the company’s performance eventually deteriorated, which made shareholders increasingly impatient. In 2004, dissident shareholders carried out a withhold-the-vote campaign, which pressured the board to name an independent chairman, who was previously the lead director, and the CEO retired shortly thereafter.

While many factors affect stock price, it is interesting to note that Disney’s shares have appreciated 30 percent in the six years since the chairman and CEO roles were split, after having fallen 20 percent in the previous five years.

The simple change I suggest to effect the separation of chairman and CEO – requiring that an independent director become chairman when a new CEO is named – would increase the rightful influence of ownership in the governance of American corporations, and lead to extinction of the Imperial CEO. This, in turn, would improve corporate performance and decrease the need for new, expensive and intrusive government regulations to control management excesses.



About the Author

| Gary Wilson structures and finances large transactions including the acquisition of Northwest Airlines; Northwest’s purchase of Continental Airlines; and Progress Rail. He also is the creator and general partner of private equity funds including Manhattan Pacific Partners, an investment fund; Thayer Lodging, a hotel investor; and Clarity China, which invests in Chinese companies.

By Margaret M. (Peggy) Foran

Meeting the Challenges of Tomorrow Today

“Offering a variety of avenues for shareholders to communicate their thoughts and concerns to the board is essential.”

At its core, corporate governance is essentially the relationship between a company, its management, its board, and its shareholders. The business fundamentals and drivers may differ across industries, but the philosophy behind good corporate governance—and the underlying processes – is very similar for all companies. It doesn’t matter if you are dealing with different businesses or industries; good boards are good boards. They always have to get the job done right, in an effective, efficient, and ethical manner, and with a view toward long-term, sustainable value. Having a passion for corporate governance, and being committed to world-class governance practices, means making sure that shareholders are heard, and that things are done in the right way. Fairness and respect for people is critical.

Successfully navigating the ever-changing landscape of the governance arena will require a constant focus on communication and engagement with shareholders, at all different levels. In addition to focusing on the governance professionals at large institutions, engaging registered and retail shareholders is also a key element that cannot be ignored.

Finding effective and innovative ways to communicate with shareholders will become increasingly vital as companies continue to compete for their attention. In 2010, Prudential focused intently on communicating with registered shareholders. Fully aware of the demand for disclosure in a format all shareholders can understand, we went to great lengths to ensure our proxy materials were written in plain language. In addition, the Governance Committee proposed a “State of the Company” letter in the proxy, signed by each director, detailing the board’s work throughout the year on compensation and governance issues. This was recognized throughout the governance arena as a groundbreaking step toward opening the lines of communication between the board and the shareholders.

As critical as it is to ensure that shareholders have sufficient information to make decisions, it is equally important that shareholders feel they have a voice, and that the company is listening. Offering a variety of avenues for shareholders to communicate their thoughts and concerns to the board is essential. In addition to the executive compensation website and the independent directors’ email address, Prudential proactively solicited feedback from shareholders on the 2010 proxy card. With over 2,600 shareholder comments received, the board gained valuable insight regarding the issues of most importance to our shareholders.

Coming up with new and effective ways to increase quorum will also continue to be a challenge in the future environment. Recognizing that, historically, registered and smaller shareholders have not participated in the proxy process, Prudential implemented a novel incentive program to encourage these shareholders to submit their vote in 2010 and became engaged in their company. Leveraging our very strong environmental sustainability program enabled us to design a very successful program that resulted in an additional 23 percent of our registered shares being voted in 2010, as compared to 2009.

We live in an exciting world and, while there have been dramatic changes, I believe we have only just begun to see the extent of the impact effective communication and engagement can have. Ongoing regulatory reform in the areas of executive compensation and corporate governance will continue to drive companies to seek better ways to communicate with and engage their shareholders. As governance professionals, we need to ensure that we are being innovative, thoughtful, and respectful, and that we continue to strive for ways to present new information in a way that people understand it, are informed by it, and provide feedback.



An MSCI Brand



About the Author

Margaret M. (Peggy) Foran is chief governance officer, vice president, and corporate secretary at Prudential Financial. She has held similar roles at Pfizer. Foran recently was appointed a director at Occidental Petroleum after the company averted a proxy fight with Relational Investors and the California State Teachers’ Retirement System.

By Lemma W. Senbet

The Rise of Equity-Based Compensation: The Bright and The Dark

“A well designed equity-based compensation can serve as a key mechanism for corporate governance.”

In thinking about the most significant development in the field of corporate governance over the last quarter of a century, I have been influenced by the two landmark events of the last decade, which have profoundly sharpened the role of finance in the public domain. In the wake of the last decade, the burst of the information technology boom and the ensuing massive corporate scandals triggered a collapse of well-known companies, such as Enron, WorldCom, and Adelphia. Moreover, by the end of the last decade, the burst of the housing bubble and the subprime crisis led to a shutdown of the credit market and a collapse of venerable financial institutions which got rescued by public funds.

There is an ongoing debate both in academic and policy circles on the extent to which corporate governance failures might have contributed to these landmark episodes. There is near consensus on the link between the scandals surrounding the dot.com bubble and failures in corporate governance. However, the link between the ill-designed incentive features of compensation and financial crisis is still being debated. It is clear, though, that executive compensation and governance in general have received wide public attention.

The last 25 years also saw a robust pay-for-performance movement. The long-standing question has been whether executive compensation structures provide sufficient incentives for executives to align them with shareholders. Agency theory suggests that the primary means by which shareholders ensure incentive alignment is to tie executive pay to company performance. In fact, consistent with this, during the late 1980s and early 1990s there was an increased pressure from institutional investors, such as the United Shareholders Association, the Council of Institutional Investors, and large state pension funds, for companies to tie executive pay closely to company performance. The pay-for-performance movement had an impact on the structure of compensation, with dramatic shift toward equity-based compensation, inclusive of both equity participation and option-based pay. The accumulated academic evidence over the years suggests that a substantial portion of CEO wealth is, in fact, tied to company performance, and better incentive alignment has been a source of increase

in shareholder wealth over the years.

However, there was a dark side to the pay-performance movement. There were several cases in which executive pay rose dramatically even though the companies were doing poorly and their stock prices were plummeting, suggesting, on the surface, insufficient linkage between pay and long-term corporate performance and the possibility that executives were paid excessively. In fact, the public concern about excessive pay led to the adoption of the Section 162 (m) of the Internal Revenue Code, which ended up creating unintended consequences by distorting the structure of composition to be heavily biased toward incentive pay, with a dramatic rise in option-based compensation.

The global financial crisis has now generated extensive debate on the role of executive pay in the propagation of the crisis. This in turn has weighed in prominently in the debate about financial policy reform pertaining to our largest financial service companies. The issue here is more about excessive risk-taking stemming from aggressive incentive features of compensation, rather than excessive pay.

Thus, over the last 25 years we have witnessed: (a) extensive debate on excessive pay; (b) the advent of 162 (m), (c) financial excesses; and (d) a crisis of epic proportions. Equity-based compensation, particularly stock option compensation, has been central to these issues. This leads me to conclude there is one aspect of corporate governance that has become the unifying link for these issues, namely the rise of equity-based compensation, and I consider this as the most significant development over the last 25 years.

The positive and the dark: Well designed equity-based compensation can serve as a key mechanism for corporate governance. Shareholder-manager incentive alignment leads to value creation and contributes to the overall economic growth and employment creation. This is positive news. However, there is also a dark side to equity-based compensation. Flawed compensation schemes can destroy value and detract from the overall economic performance. As an example, compensation schemes that motivate excessive focus on



An MSCI Brand

short-term profits to meet short-run analysts' expectations can destroy long-run shareholder value. Moreover, if the stock is overvalued, equity-based compensation may incentivize the manager to over-invest or manipulate earnings to justify the firm's current stock price. Some have convincingly argued that such manipulations have contributed to the corporate scandals surrounding the dot.com bubble (Jensen 2005).

Excessive pay debate: There is also a widely held view that executive compensation in the U.S. is excessive in the sense it is higher than that required to retain and motivate executives. In the 1990s average CEO compensation increased significantly, both in absolute and in relative terms. The inflation-adjusted level of average CEO pay for S&P 500 companies stood at \$14.7 million in 2000, five times the average 10 years before. On another metric, the 2000 level was about 400 times that of average employee compensation, up from only 42 times in 1980 (see *Business Week*, Sept. 11, 2000).

But what is excessive? Presumably it is higher pay than the executive could command in a competitive market for executives. It is safe to say there have been instances of mega stock option grants being made to undeserving top-level executives. For instance, Dennis Kozlowski, former CEO of Tyco, was granted nearly six million options valued at \$81 million at the very time that he was allegedly looting the company. However, it is difficult to generalize from these cases about whether the average level of executive compensation was excessive.

Section 162 (m) and the rise of option-based compensation: Section 162 (m) was enacted in 1993 as a means of mitigating excessive pay. The statute disallows tax deductibility for all compensation paid to "proxy-named executives" in excess of \$1 million, unless such compensation is "performance-based." However, it ended up creating unintended consequences. On an after tax basis, performance-based compensation, particularly stock options, became less expensive than base salaries and stock grants. Stock options did satisfy the "performance-based" test, since they are directly linked to the underlying stock. This must have led to a dramatic rise in option-based compensation. In fact, the average grant-date value of options soared from near zero in 1970 to over \$7 million in 2000 (Hall and Murphy, 2003).

Overly generous compensation packages with large-sized stock option grants may have created incentives for managers to manipulate company financial statements in order to drive up stock prices, contributing to the corporate scandals of the post-dot-com era.

Executive pay and financial crisis: Executive compensation has been a prominent and visible target of regulators and policy makers in response to the crisis. A key question in these policy responses is whether, and to what extent, flawed compensation structures at financial firms contributed to the crisis. Given that shareholders of levered institutions benefit from excessive risk, paying executives

with stock or options and aligning them with shareholders can have the perverse effect of pushing executives to take on extra risk.

There is evidence suggesting that the incentive structure of pay is different between financial and non-financial firms (DeYoung, Peng, and Yang (2009)). In particular, the sensitivity of executive pay to volatility (vega) diverged between banks and non-banks after 1999. As a consequence, an argument can be made that there were incentives for excessive risk-taking, as reflected in more credit risk and more private mortgage securitizations. One consequence of this form of risk-taking is an elevated level of systemic risk in which banks become especially stressed during economic downturns.

However, this is suggestive and a causation is yet to be established. Overall, whether flawed incentives in compensation are the critical driver of the financial crisis remains an empirically interesting question for future research.

"Overly generous compensation packages with large-sized stock option grants may have created incentives for managers to manipulate company financial statements in order to drive up stock prices, contributing to the corporate scandals of the post-dot-com era."

LOOKING AHEAD: THE NEXT 25 YEARS

I make the following predictions based on a simple guiding principle that I believe will prevail over the next 25 years. The principle is that the level of executive pay should not be legislated or regulated, directly or indirectly. In particular, the choice of compensation structures should be left to the firm, and regulatory and tax reforms should not favor one form of compensation over another.

1. Section 162 (m) will be repealed. This rule is a misguided effort to regulate the level and structure of executive compensation, and should be repealed. Companies, through their boards and shareholders, will be free to determine the optimal form and level of executive compensation. In those cases where corporate boards are not exercising this function in a responsible way, there will be changes in corporate governance institutions or other mechanisms (e.g., "say on pay") to enhance the power of shareholders to monitor executive compensation directly.

2. Longer vesting periods will prevail: Due to longer vesting periods, there will be improved linkage of pay to long-term performance and less to cash out based on short-term favorable results. Even bonuses will be based on multi-year metrics to better align executives with long-term shareholder wealth maximization.

3. Shareholders will directly influence executive pay: Shareholders will have a more direct mechanism for influencing the level and structure of executive compensation. All top-management compensation plans, including salary, equity-based compensation, and severance packages will be subject to a shareholder proxy vote. Due to limited experience and information possessed by individual shareholders, an advisory vote will prevail in well-governed companies. Thus, good governance will be rewarded.

4. Compensation committees will be independent and finance

“This crisis has inspired more, and even invasive, regulation both in the financial and non-financial sectors, and the role of the government in corporate governance and financial regulation has actually expanded.”

literate: Compensation committees will be composed entirely of independent directors to ensure that compensation is set in an arms-length bargaining process. The committees will be aided by compensation committees supported by independent compensation consultants.

Equally important, compensation committees will have sufficient expertise in finance to sufficiently understand the compensation contracts and the methods used to value properly the incentive features in these contracts.

5. There will be more expanded disclosure involving all elements of pay: Disclosure will be more explicit and expanded to cover all elements of executive compensation, including retirement benefits, severance packages, perquisites, and other direct or indirect schemes of compensation. Moreover, financial transactions by executives, particularly hedging transactions, that affect pay-performance sensitivity, will be disclosed to boards and compensation committees.

6. There will be increasing state dominance of governance around the world: We have already witnessed the advent of pay czar as a consequence of TARP bailouts. For the first time in history, the

financial crisis led the U.S. government to acquire exorbitant ownership stakes in our largest companies. It has also emerged as a dominant creditor.

This crisis has inspired more, and even invasive, regulation both in the financial and non-financial sectors, and the role of the government in corporate governance and financial regulation has actually expanded. Thus, the role of the government in corporate governance, including executive pay, through direct ownership and implicit guarantees is likely to increase unless the pendulum shifts as a result of some backlash from industry.

However, the increasing role of the government is consistent with what is happening around the world, since state-owned corporations in fast growing BRICs (Brazil, Russia, India, and China) have emerged as serious competitors to the traditional corporations, with the resultant state capitalism emerging as an alternative form of the traditional corporate governance. At this time it is difficult to predict the economic consequences of the global trend in the increased state role in governance of corporations.



An MSCI Brand



About the Author

Lemma W. Senbet is the William E. Mayer chair professor of finance and director of the Center for Financial Policy at the Smith School of Business at the University of Maryland. His colleagues, Michael Faulkender, Dalida Kadyrzhanova, and N. Prabhala, contributed to this article.

By Frederic W. Cook

Who Controls the Executive Compensation Program?

“The likelihood of continued high pay for executives and increasing ratios of executive’s pay to average workers will keep executive pay a hot issue, useful to those who wish to undermine board prerogatives or achieve other objectives.”

The most significant development in corporate governance of executive compensation during the past 25 or so years has been the shift in power to control a public company’s executive compensation from the management and its staff to the board’s compensation committee and its independent advisers.

This shift has been part of a larger initiative to make boards more independent, active, and even proactive in exercising their fiduciary responsibilities to oversee the activities of the company and to hire and compensate the CEO and management.

I mark the start of this movement to the actions by CalPERS to prevent the retiring CEO of General Motors from remaining on the board, and, later, to install an independent director as chairman of the board. The then-prevailing “Wall-Street rule” was that if investors did not think a company was well run, they should sell the stock; otherwise, they should not interfere. CalPERS, a very large investment manager of pension funds for state employees in California, decided to buck the Wall Street rule. Its reasoning was that due to the size of its holdings, it was difficult to sell its position in individual stocks without disrupting the market. So, instead of selling shares, it adopted a strategy to become an activist investor to change board governance to make it more responsive to shareholders’ concerns.

Back then it may be said that many boards were inward looking, rather than actively focused on advancing shareholders interests. Boards were less independent than today, with new directors often nominated by the CEO himself. While the board technically controlled the executive pay program, the practical reality was that it was heavily influenced by proposals and policies developed by management. Expert advisers, to the extent they were involved at all, were not independent and working on behalf of the Compensation Committee, but rather were retained by and beholden to management. The result was pay programs that, while modest in magnitude by today’s standards, were less focused on performance-based compensation and more focused on deferred compensation, special benefits, and perquisites. Executives tended to be home grown and to stay with the company their whole career, for better or worse. One bright spot in this otherwise weak model was that executives

tended to regard themselves as custodians of the corporation. This mindset fostered a high degree of loyalty and commitment to improve the corporation’s performance and to leave it in better shape for their successors than when they started.

CalPERS was soon joined by other activist investors and take-over types, such as T. Boone Pickens and Carl Icahn, who recognized opportunities to profit through targeted investments in companies with weak management and depressed stock prices by taking big investment positions and forcing change. These events led to responses by corporations to protect their independence (poison pills), protect management (golden parachutes), and buy off the aggressor (green mail).

Notwithstanding these defensive reactions, boards gradually started turning their attention outward to advance shareholder interests. This shift in focus was deftly reinforced by a substantial change in managerial incentives from an operational focus (i.e., profits) to a shareholder focus (i.e., changes in stock price). This change in focus from internal managerial interests to external shareholder interests was reinforced by the new notion introduced during this time that the primary purpose of a public corporation was to **maximize the value of the corporation for shareholders.**

The changes in managerial incentives to align executives’ interests with the interests of investors in better performance have had some very positive effects on the typical executive compensation program:

- More variability in pay earned by performance,
- Stock ownership guidelines and retention ratios,
- Reduction in employment agreements and moderation of severance/CIC provisions,
- Elimination or substantial diminution of executive perks, special benefits, supplement executive retirement plans, tax gross ups, and
- Elimination of special retirement benefits and perks for retiring CEOs.

Like most evolutionary changes, this shift in focus to shareholders’ interests has had consequences that some may regard as negative:



An MSCI Brand

- Short-term behavior to meet or beat analysts' earnings estimates,
- Tendency to treat employees and employee benefits as a cost rather than as an asset, and
- A convergence of executive compensation design and practice into a "one-size fits all" approach that meets the "check-the-box" requirements of activist shareholders and their advisers.

Finally, the shift in control over executive compensation from management to independent compensation committees has had the following positive governance effects:

- Increased focus on variable cash- and equity-based compensation, which fosters greater alignment between realized pay and company performance as measured by both operating results and changes in shareholder value,
- Enhanced level of executive ownership in the stock of companies they lead, which creates commonality of interest with shareholders,
- More transparency in disclosure of executive pay as well as the accountability of compensation committees,
- More balanced and reasonable peer groups for setting target pay and for comparing actual, realized compensation as well as performance against the market,
- Better use and less misuse of survey data to justify executive pay,
- Shift in control of compensation consultants from management to the compensation committee, and
- Transfer of responsibility for CEO pay analyses and recommendations from the CEO's staff to the Committee's independent advisers.

"Investors will also need to recognize that compensation policy is a strategically important dynamic for a corporation, and that individual design (rather than strict adherence to broad 'best practice' principles) can have a profound effect on the degree to which the overall program supports sustainable value creation for long-term investors and other stakeholders."

What will the future hold for corporate governance of executive compensation? In my experience, most trends continue until a disruptive force occurs that starts a new trend. Absent such a disruptive force, I envision a further shift in power over executive compensation from the board to shareholders as a result of several factors. These include legislative and regulatory developments such as "say on pay," proxy access, and majority voting, as well as the growing influence of activist investors and proxy advisory firms to influence voting outcomes and punish directors who are insufficiently attentive to their demands. Finally, the likelihood of continued high pay for executives and increasing ratios of executive's pay to average workers will keep executive pay a hot issue, useful to those who wish to undermine board prerogatives or achieve other objectives.

Whether such change will be positive depends on two factors: the investors' agenda and the degree to which they are sufficiently informed. There is a danger that investor power may be used to facilitate a political or social agenda rather than an appropriate business purpose. And even if investors use their influence to support appropriate business goals, the value of their influence is very much dependent on knowledge of how executive compensation systems actually operate. For example, in forming views on the relationship between pay and performance, investors must recognize

the distinct difference between theoretical, or target, pay and realized value (e.g., Black-Scholes value versus realized option gains). Investors will also need to recognize that compensation policy is a strategically important dynamic for a corporation, and that individual design (rather than strict adherence to broad "best practice" principles) can have a profound effect on the degree to which the overall program supports sustainable value creation for long-term investors and other stakeholders.

The one thing we can be assured of is that compensation policy and related governance processes will continue to evolve, as they should.



About the Author

- Frederic W. Cook is the founding director of Frederic W. Cook & Co., a compensation consulting firm. Before founding the firm in 1973, he worked as a principal at Towers Perrin.

By Stephen Griggs and
Judy Cotte

‘Say on Pay’ Arrives in Canada

“The results of ‘say on pay’ votes held have been overwhelmingly positive.”

One of the most recent significant governance developments in Canada has been the arrival of shareholder advisory votes on compensation, commonly known as “say on pay.” The unique approach to “say on pay” in Canada is noteworthy and speaks to the power shareholders have to affect significant change without regulatory intervention.

The movement toward “say on pay” in Canada began in earnest in 2009 when approximately 17 shareholder proposals for “say on pay” were filed with Canadian companies, many of which received majority support. Many of these proposals were filed by Canadian investor advocate *Mouvement d’éducation et de défense des actionnaires* or with the assistance of the Shareholder Association for Research and Education. Ultimately 14 large Canadian companies, including all of Canada’s banks, agreed to give their shareholders a “say on pay” vote.

At the same time, shareholder proposals requesting “say on pay” were being filed in the United States and numerous companies had agreed to provide it to shareholders. There was little uniformity in the resolutions put to shareholders, however, which led to difficulty comparing vote results between companies. Although legislating “say on pay” was already being discussed in the United States, Canadian regulators and lawmakers did not show any interest in the issue. The Canadian Council on Good Governance (CCGG) decided to get involved to ensure that “say on pay” resolutions in Canada were consistent, encouraged companies to engage constructively with their shareholders, and offered shareholders a meaningful way to communicate their views on executive compensation.

CCGG AND “SAY ON PAY”

In the summer of 2009, CCGG began to develop its policy on “say on pay”. In doing so, CCGG worked with the 14 companies that had agreed to hold “say on pay” votes to ensure that it considered their perspective and any practical obstacles to implementing “say on pay.” An important part of CCGG’s policy was the formulation of a model resolution that could be used by all companies holding “say on pay” votes. The CCGG model resolution reads as follows:

Resolved, on an advisory basis and not to diminish the role and responsibilities of the board

of directors, that the shareholders accept the approach to executive compensation disclosed in the Company’s information circular delivered in advance of the [insert year] annual meeting of shareholders.

The resolution is not focused on the quantum of compensation but rather on the policies and procedures that reveal a company’s approach to executive compensation, although quantum could, in some circumstances, be relevant. A company’s approach to compensation should reflect the links between its strategic objectives and compensation, using financial and non-financial measures over a number of years. All 14 companies first offering “say on pay” in Canada agreed to use CCGG’s form of resolution. We believe that this cooperative approach of developing a workable “say on pay” policy in conjunction with corporate issuers has been unique to Canada.

“SAY ON PAY” GAINS ACCEPTANCE

“Say on pay” has continued to gain acceptance across Canada. To date, 42 companies, approximately 20 percent of the S&P/TSX Composite Index, have adopted “say on pay,” and numerous others have confirmed to CCGG that they intend to do so. Adoption of “say on pay” has been broad-based and includes companies from virtually all industries and market capitalizations. All companies adopting “say on pay” have continued to use CCGG’s recommended form of resolution (with one non-material variation), which will simplify the process for shareholders and allow for a meaningful comparison of vote results between companies. As recommended by CCGG, all companies are also holding their votes annually.

The results of “say on pay” votes held have been overwhelmingly positive. Of the 42 companies that committed to “say on pay,” 25 included the resolution in their 2010 proxy ballots. The votes in favour of the company’s approach to executive compensation ranged from 86.3 percent to 99.2 percent with the average at 94.39 percent. This high level of support likely indicates that companies are reaching out, at least to their largest shareholders, to discuss their approach to executive compensation in advance of any “say on pay” vote. It also suggests that shareholders will use their advisory vote responsibly, as has been the experience in other jurisdictions.



An MSCI Brand

“All but one of the companies that have adopted ‘say on pay’ have also adopted majority voting, suggesting that the rate of acceptance of say on pay might mirror that of majority voting.”

CCGG has already noticed significant improvements in the disclosure practices of companies that have adopted “say on pay” and some have also improved their compensation plans. CCGG encouraged companies to provide shareholders with a plain language overview of their compensation plans, including a description of the company’s key strategic objectives and how compensation is structured to motivate management to achieve those objectives while also managing risk, and several companies have already done so. Perhaps more importantly, several companies have made significant changes to their compensation plans to better align executives’ compensation with their performance. In addition, numerous companies have included in their circular a commitment to engage with their shareholders, both large and small, and have provided a description of the engagement process they intend to follow.

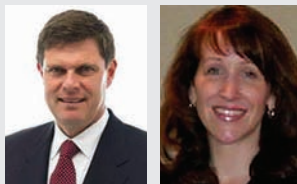
THE FUTURE OF “SAY ON PAY”

CCGG expects that the number of companies adopting “say on pay” in Canada will continue to increase. Our experience with majority voting in Canada may prove prescient in that regard. In 2005, CCGG urged Canadian companies to adopt a majority voting policy which would effectively allow shareholders to vote “for” or “against” directors, in spite of the fact that plurality voting is enshrined in Canadian corporate and securities laws. Although the idea initially met with resistance, approximately 127 companies,

55 percent of the S&P/TSX Composite Index, have since adopted CCGG’s majority voting policy.

Indeed, all but one of the companies that have adopted “say on pay” have also adopted majority voting, suggesting that the rate of acceptance of say on pay might mirror that of majority voting. It may also suggest that companies with majority voting, where directors face the possibility of being removed by shareholders, recognize that “say on pay” votes provide shareholders with a middle ground that benefits boards as well as shareholders. If shareholders are dissatisfied with a board’s approach to executive compensation, they can express their views through a negative “say on pay” vote rather than taking the more extreme step of voting against directors.

Although “say on pay” is very new to Canada, early indications suggest that it will have a positive impact. Some companies are showing an increased willingness to engage with shareholders, improving the disclosure of their compensation plans, and improving the linkages between pay and performance. Moreover, the fact that “say on pay” was brought to Canada by shareholders, in cooperation with Canadian companies and without any support from regulators, is a reminder of the power shareholders have to improve corporate governance when they work together collaboratively.



About the Authors

Stephen Griggs is the executive director of CCGG and Judy Cotte is the general counsel and director of policy development. CCGG is a coalition of most of Canada’s largest institutional investors who collectively manage approximately \$1.4 trillion in assets.

By Hye-Won Choi

Keys to Reform Over the Next 25 Years

“Corporate governance is more than declassifying boards or completing a social responsibility report—it is about making sure companies’ governance processes address conflicts, align interests, and increase the likelihood of good decision making so that companies are able to reach their objective of maximizing long-term performance and shareholder value.”

We are at a critical juncture in corporate governance in the United States. Many of the structural reforms that shareholders have asked for have been implemented. Many leading companies have adopted best practices such as majority voting in director elections. The Dodd-Frank legislation provides shareholders with additional rights including the advisory vote on compensation and proxy access. The reforms are a step in the right direction and an attempt to strengthen transparency and accountability but structural reforms are not enough to bring about better corporate governance. For markets to work well and be efficient, shareholders and companies must do their part to ensure that the goal of the reforms are achieved.

In my view, the primary goal of the reforms, whether it is the advisory vote on compensation or proxy access, is to encourage collaboration between companies and shareholders to develop private solutions to governance problems. Here are some ideas on how this can be achieved:

- There needs to be greater dialogue between companies and shareholders and a desire to develop private solutions to governance problems. Both shareholders and companies should recognize that it is in their mutual interest to seek common ground rather than be confrontational. Shareholders and companies should talk. The discussions could take a variety of forms, whether they are in-person or telephonic and could cover a range of governance policy issues in addition to financial and economic issues. We need to develop models that are flexible and yet meaningful and engender increased trust and understanding, leading to a better alignment of interests between companies and shareholders.
- These discussions should lead to the creation of market-based solutions to governance problems rather than more legislation, which can restrict flexibility if it is too prescriptive. Market-based solutions are the ideal and for this to happen, shareholders and companies must work together to develop solutions to governance concerns. However, private ordering cannot be successful if companies are reluctant to take on reforms for fear of being competitively disadvantaged.
- Companies need to change their way of thinking. Governance is not simply compliance items or box checking. Governance should not be interpreted as short-term measures or things that proxy advisory firms want but not shareholders. Governance should be integrated with strategy, performance, and goals. Corporate governance is more than declassifying boards or completing a social responsibility report – it is about making sure companies’ governance processes address conflicts, align interests, and increase the likelihood of good decision making so that companies are able to reach their objective of maximizing long-term performance and shareholder value.
- Shareholders should understand that the goal of governance is not simply to vote every proxy but to enhance returns by reducing risk. Companies that do not have proper board oversight of management, do not have rational compensation policies aligned with shareholders, do not have effective controls of risk, and do not have a strong management team increase their investment risk. Good corporate governance is not a guarantee that companies will perform well but it certainly is a contributing factor. Shareholder policies and practices should be driven by the need to increase the long-term value of their holdings and generate good returns for underlying beneficiaries.
- Shareholders should also understand that it is the role of the board and management to run companies and should not try to micromanage or encroach upon the responsibilities of boards. Boards on the other hand should clearly articulate what they are trying to do with the company and the company’s business strategy over the short- and long-term and then ensure management executes on the strategy.
- Executive compensation will continue to be an issue of concern for shareholders. Compensation decisions are a measure of the board’s performance and independence. Compensation committees will need to clearly articulate the rationale and philosophy behind their decisions. Shareholders should respond by voting on the quality of the reasoning. Shareholders should evaluate whether the board has set policies that are long-term oriented, integrated with business strategy, and designed to drive value.



An MSCI Brand

“Shareholders should ensure that their internal governance policies and practices are consistent with the policies that they advocate for the companies they own. They should make sure to properly address and manage conflicts and devote appropriate resources to proxy voting and governance analysis.”

- Succession planning and risk management will become greater priorities for companies. Boards must look ahead five to 10 years and set strategy and goals and identify the company’s most significant challenges. Boards must make sure they have an executive team in place that can execute on strategy and ensure that financial incentives are aligned with meeting clearly articulated milestones without excessive risk-taking that could undermine the long-term sustainability of the company.
- Proxy advisory firms, while coming under greater scrutiny, will continue to provide the necessary service of providing recommendations on proxy decision-making. It should be recognized that such research is not developed in a vacuum and reflects an amalgamation of the views of large institutions. Ultimately, however, the advisory firms provide only recommendations; the decisions are the responsibility of investors who should vote in alignment with their economic interests and should communicate their policies to companies and the market. The advisory firms also provide supplemental research used by shareholders to identify outlier companies to be included in governance initiatives and campaigns.
- Shareholders should ensure that their internal governance policies and practices are consistent with the policies that they advocate for the companies they own. They should make sure to properly address and manage conflicts and devote appropriate resources to proxy voting and governance analysis.
- Shareholders and companies should be more mindful of the need to integrate concerns about social responsibility into business planning. Socially responsible practices may help mitigate risk for corporations. For shareholders, reducing negative externalities, such as pollution, can help to mitigate portfolio risk as well. Companies should examine sustainability related risks, develop strategies to address them, and disclose the results of their deliberations.



About the Author

■ Until September 2010, Hye-Won Choi served as senior vice president for corporate governance at TIAA-CREF. In 2009, she was appointed co-chair of the Securities and Exchange Commission’s Investor Advisory Committee.

By Martin Lipton

The Future of Corporate Governance and the Board of Directors

“Institutional shareholders, hedge funds, activist investors, and corporate raiders are today able to exercise considerable influence over both corporate governance matters as well as key business decisions of public companies, and takeover defenses have been significantly scaled back.”

Much has changed in the corporate governance landscape over the past 25 years and, without a doubt, Institutional Shareholder Services has played a central role in shaping its evolution. Since ISS was formed in 1985, it has been at the forefront of a crusade by public and union pension funds, academics, activist shareholders, and corporate raiders for a shareholder-centric governance system.

Today the crusade has accomplished virtually every objective that it originally set out to achieve. The shareholder rights movement has steadily pushed forward, spurred by the SEC’s shareholder communications rules adopted in 1992, and then galvanized by the Enron scandal in 2001 and the financial crisis starting in 2007, both of which precipitated extensive legislative and regulatory changes that encompassed many of the policies promoted by ISS. Institutional shareholders, hedge funds, activist investors, and corporate raiders are today able to exercise considerable influence over both corporate governance matters as well as key business decisions of public companies, and takeover defenses have been significantly scaled back.

In an effort to think about the future of corporate governance and the board of directors, we need to start with what we expect the board to do today and the rules we have set governing how directors are selected, how they function, and how they relate to shareholders—not only the legal rules but also the aspirational “best practices” that influence corporate and director behavior. We also need to look at how corporate management and boards are perceived by the media, the public, and elected officials in the post-financial crisis era, and examine the reputational and other non-legal pressures that directors face.

We expect boards to:

- Choose the CEO, monitor his or her performance, and have a detailed succession plan in case the CEO becomes unavailable or fails to meet performance expectations.
- Plan for and deal with crises, especially crises where the tenure of the CEO is in question, where there has been a major disaster, or where

hard-earned reputation is threatened by product failure.

- Determine executive compensation, achieving the delicate balance of enabling the company to recruit, retain, and incentivize the most talented executives, while avoiding media and populist criticism for “excessive” compensation.
- Interview and nominate director candidates, monitor and evaluate the board’s own performance, and seek continuous improvement in board performance.
- Provide business and strategic advice to management and approve the company’s budgets and long-term strategy.
- Determine the company’s risk appetite (financial, safety, reputation, etc.), set state-of-the-art standards for managing risk, and monitor the management of those risks.
- Monitor the performance of the corporation and evaluate it against the economy as a whole and the performance of peer companies.
- Set state-of-the-art standards for compliance with legal and regulatory requirements, monitor compliance, and respond appropriately to “red flags.”
- Take center stage whenever there is a proposed transaction that creates a seeming conflict between the best interests of stockholders and those of management, including takeovers, mergers, and restructuring transactions.
- Set the standards of social responsibility of the company, including human rights, and monitor performance and compliance with those standards.
- Oversee government and community relations.
- Pay close attention to investor relations and interface with shareholders in appropriate situations.
- Adopt corporate governance guidelines and committee charters.

We require the board to be made up of a majority of independent directors. While the rules of the stock exchanges require only a majority, the guidelines of many institutional investors and governance advisory organizations have specified a “substantial” majority or a specific percentage. In fact, many major corporations today have boards whose only



An MSCI Brand

non-independent director is the CEO. Further, the definition of independence is periodically adjusted by governance activists and advisory organizations to be more stringent than the definition in the stock exchanges rules.

It is interesting to note, however, that director independence is not clearly the fundamental keystone of “good” corporate governance. The world’s most successful economy was built by companies that had few, if any, independent directors. It was not until 1956 that the New York Stock Exchange *recommended* that listed companies have two outside directors and it was not until 1977 that they were *required* to have an audit committee of all independent directors. In 1966 when the Standard Oil Company added outside directors, the New York Times reported that it would require the board to rethink its schedule of meeting *every day* at 11 a.m.

In addition to independence, we think directors should have relevant business experience, leadership ability, and the strength of character to challenge management. Finally, we seek gender and ethnic diversity; availability, and commitment such that few if any board and committee meetings are missed; and willingness to serve for compensation that does not fully reflect the scope of the expected commitment and the exposure to litigation and reputational damage when something goes wrong.

The combined effect of the Sarbanes-Oxley Act, the Dodd-Frank legislation, the stock exchange governance rules, SEC regulations, and pressure from ISS and other advisory organizations is to exalt short-term shareholder interests over the interests of other stakeholders—and of the American economy and the American public. The assumption that empowering shareholders and promoting their interests will lead to better performance and more efficient management of corporations, and that shareholder interests are therefore aligned with those of other stakeholders, is simplistic and contradicted by the short-term trading objectives of many of the major institutional investors and hedge funds. To quote the title of a brilliant speech Vice Chancellor Leo Strine of the Delaware Court of Chancery gave at Stanford University in May 2010: “One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed For The Long Term Unless Their Powerful Electorates Also Act And Think Long Term?”

While the upheaval precipitated by the recent financial crisis has not fully settled and the contours of the post-crisis corporate governance landscape are still being shaped, some corporate governance policies have become firmly entrenched and will very likely continue to hold sway, whereas others may continue to develop and/or emerge as particularly relevant to boards of directors. A few thoughts about the future corporate governance and board functioning of public companies are set out below, although each company will need to assess and tailor its policies in view of its individual circumstances.

“The world’s most successful economy was built by companies that had few, if any, independent directors.”

Director Independence. There will continue to be a substantial majority of independent directors on corporate boards. There will be significant gender and ethnic diversity. While we will not prescribe percentages for gender diversity, we will be somewhere between the new U.K. Corporate Governance Code: “The search for board candidates should be conducted, and appointments made, on merit against objective criteria and with due regard for the benefits of diversity on the board including gender” and the 40 percent female quota imposed by law in Norway and actively being considered or adopted in other European countries.

The trend toward smaller boards will be reversed in order to have a sufficient number of independent directors for the audit, nominating, and compensation committees and to add directors who have special expertise and are not necessarily independent. For example, the financial crisis called attention to directors of financial institutions who did not have the expertise to fully understand the risks of complicated derivatives and other high-tech financial instruments. To remedy the situation, the banking regulators are now insisting that experienced bankers be added to the boards.

Board Committees and Director Education. A separate risk committee has been mandated for financial institutions and, even if not mandated for non-financial companies, will likely become common at companies where risk plays a significant role. For example, the BP Gulf of Mexico spill, and BP’s acknowledgment that it was not prepared for it, followed a BP refinery explosion in 2005 that resulted in a special review, by a committee chaired by James Baker, that criticized the BP board for not properly monitoring the risk of that type of accident. To assist boards and committees with evaluating and monitoring risks and other specialized or complex issues, there will be greater resort to obtaining opinions of expert consultants. Boards will have regular tutorials by both company employees and outside experts. Board retreats for two or three days will have longer agendas to fulfill the need for director education about specialized issues.

Director Duties. To date our courts, even in cases involving multi-billion-dollar losses by financial institutions, have continued to adhere to the customary *Caremark*-case standard for determining whether directors have met their duties of care. Earlier this year, however, the European Commission, in a consultation paper seeking comments on options to improve corporate governance in financial institutions, suggested strengthening “legal liability of directors via an expanded duty of care.” And the possibility that higher standards of care could eventually be imposed not only on directors of financial institutions, but on directors of all corporations, is real. Specialized committees, use of expert consultants, tutorials, and expanded director education programs will go a long way to enable boards to meet even a strengthened duty of care.

Time Demands of Board Service. Looking out even further into the future, the time demands of board service will result in more use of modern conferencing and communication technology so

that travel time is reduced, committees can meet conveniently apart from meetings of the whole board, and special meetings with outside consultants can be convened whenever needed. In dealing with important issues and crises, companies will have very frequent special meetings and resort widely to outside experts.

As a result of the increased time demands of board service, combined with liability risks, potentially higher standards of care, and the need for larger, more diverse boards with special expertise, director recruiting will become an increasingly critical challenge for many corporations. There will be a significant increase in director compensation in order to meet the increased commitment of time directors will need to make and the increased threat of legal or reputational damage to which they are exposed.

Separation of Chairman and CEO. This is the one key governance change that the governance activists have not yet achieved. While separation of chairman and CEO roles was ultimately dropped from the Dodd-Frank legislation, it does require disclosure of whether the roles are split—something the SEC had already required companies to discuss in proxy statements. In light of the strong support for separation in the activist governance community and the implicit endorsement by Congress and the SEC, pressure through shareholder proxy resolutions will continue to grow. It is reasonable to assume that in a few years separation will be more widespread.

Shareholder Control. In addition to advisory shareholder voting on executive compensation (“say on pay”) prescribed by the Dodd-Frank legislation and proxy access adopted by the SEC following authorization by Dodd-Frank, SEC rules permit proxy resolutions designed to induce or force the company to (a) dissolve takeover defenses, (b) make it easier for shareholders to call special shareholder meetings, (c) authorize shareholders to act by written consent instead of a shareholder meeting and conduct campaigns to obtain full control, and (d) enable shareholders to shape director nominating procedures and CEO succession planning. Together with NYSE rules, effective 2010, that eliminated broker discretionary voting in uncontested elections, activist institutional shareholders will be more able to heavily influence, if not dictate, business actions, policies, and strategies at most major public companies.

This review of the corporate governance landscape raises some ultimate questions:

- Will we be able to attract the qualified directors we need in light of the limitations on their ability to take actions and adopt policies that shareholders seeking short-term performance object to?
- Will the pressure for short-term performance lead to the “Eclipse of the Public Corporation,” a 1989 prognostication by famed Harvard economist Michael Jensen?
- Will the pressure for short-term performance result in business decisions that so adversely affect stakeholders and the economy that the government is forced to become intrusive in the management of public corporations or to limit the power of shareholders to influence boards of directors?

While these are reasonable ruminations, I think that they will not come to pass. Instead, companies and their advisers will adjust to the reality of the new governance regime and the responsibilities of CEOs and boards of directors will become more challenging. And, hopefully, we will over time realize the drawbacks of conceptualizing corporate governance as primarily a means to discipline managers, to arbitrarily limit the compensation of executives, and to provide convenient ways for institutional and activist shareholders to dictate corporate policy in order to achieve their

short-term profit interests. Instead, we should recognize that the purpose of corporate governance must be to encourage management and directors to develop policies and procedures that enable them to best perform their duties (and meet our expectations), while not putting them in a straitjacket that dampens risk-taking and discourages investing for long-term growth and true value creation. The Sept. 23, 2010, report of the NYSE Commission on Corporate Governance recognizes the problem and states the first principle of governance as follows: “The board’s fundamental objective should be to build long-term sustainable growth in shareholder value for the corporation....” Hopefully, along with a nascent academic recognition of the problem, the NYSE report presages an evolution that will reverse the unfortunate consequences of the corporate governance developments of the past quarter-century.

“We should recognize that the purpose of corporate governance must be to encourage management and directors to develop policies and procedures that enable them to best perform their duties (and meet our expectations)...”



An MSCI Brand



About the Author

- Martin Lipton, a founding partner of Wachtell, Lipton, Rosen & Katz, specializes in advising major corporations on mergers and acquisitions and matters affecting corporate policy and strategy and has written and lectured extensively on these subjects.

By Bonnie Hill

The Federalization of Corporate Governance and its Unintended Consequences

“The boardroom is not a place for politics, but rather a place where the interest of all shareholders must be considered rather than that of a select few or those with special interest.”

Prior to the Sarbanes-Oxley Act of 2002 (SOX), corporate governance was generally considered to be a matter of state law and was largely addressed in an apolitical manner by state legislatures and courts. We had an open marketplace of ideas trying to reach consensus on what constitutes good governance - policies that are consistent with the rights of shareholders, yet best for economic growth ...with the shareholders being the ultimate deciders. And it has had its effects—wide acceptance of majority vote, decline in poison pills, increased responsiveness to nonbinding shareholder votes, and increased communication between boards and shareholders, to name a few. Today, however, that marketplace is being replaced by politics—Congressional directives that lead to increased cost, uncertainty, and unintended consequences as politicians lurch from idea to idea based on the whims of a given constituency.

Within the open marketplace during the past twenty-five years, ISS has evolved as a dominant force in proxy and corporate governance advising, along with Glass Lewis, GovernanceMetrics International, The Corporate Library, and several others. Furthermore, each proxy season a number of activist investors and self-appointed governance experts submit shareholder proposals with an expectation that the proxy advisors will recommend “for” their proposals. In most cases, management either fights the proposals or reaches a compromise with the advocates. This has been an annual ritual as boards of directors struggle to implement best practices. At the same time, these boards must make decisions with calculated risks believed to be in the best interests of shareholders. These directors are a diverse group of individuals from business, academe, not-for-profits, and government. They are elected by the shareholders, and together they bring a breadth of experience and provide a critical balance to the decision-making process in the boardroom.

Since the enactment of SOX, also known as the Public Company Accounting Reform and Investor Protection Act (in the Senate), and Corporate and Auditing Accountability Responsibility Act (in the House), we have seen other federal laws targeting

corporate governance that are equally politically driven, leading to what I call the Politicization of Corporate America. Politicization in this context is the replacing of the open marketplace of governance ideas with the judgment of Congress, which is in essence reactive, short-term thinking, with insufficient appreciation for the cost and unintended consequences of the regulation. There is a significant body of academic research and opinions regarding the costs and benefits of SOX and no general consensus on either. What became clear however was that, contrary to what was intended, SOX substantially increased the annual audit costs of publicly-traded companies, particularly with respect to compliance with Section 404. And, it is clear that small public companies were disproportionately penalized with regard to the cost of compliance, another unintended consequence that is currently being corrected.

Aside from the philosophic issue of whether it is appropriate for the federal government to usurp the role of the states in this area, there is general agreement in corporate America that the politicization that we have seen since SOX has long-term negative ramifications. Even in areas which were traditionally the province of the federal government - e.g., securities regulation - we are seeing Congress get involved for political reasons. For example, we have proxy access because Congress authorized the SEC to make it happen. Whether or not proxy access in the form adopted is a good or bad idea is not the issue. What is at issue is the unanticipated consequences. It appears that Congress is giving more power to special interests to the detriment of shareholders generally and larger investors with greater economic risk.

The boardroom is not a place for politics, but rather a place where the interest of all shareholders must be considered rather than that of a select few or those with special interest. It is a place where business experience is critical and where decisions that involve risks must be weighed against both the long- and short-term benefit for all shareholders in an unbiased, rational manner with the best expert advice available rather than politics. Unfortunately, unless the trend of politically driven corporate



An MSCI Brand

“Unfortunately, unless the trend of politically driven corporate governance enacted by Congress is reversed, American free enterprise with its jobs and value creation will be jeopardized.”

governance enacted by Congress is reversed, American free enterprise with its jobs and value creation will be jeopardized.

The past twenty-five years have seen unprecedented changes in corporate governance. There have been periods of great prosperity and periods of recession. We have seen corporate corruption and government dysfunction. And in all of this, somehow the belief that government has the answer for corporate America is not a comforting thought. It is my belief that the open marketplace as we’ve known it is still the best hope for the continued prosperity of America’s free enterprise system.



An MSCI Brand



About the Author

Bonnie Hill is president of B. Hill Enterprises, a corporate governance consulting firm. She is also co-founder of Icon Blue, a boutique brand-marketing company. Hill has over 36 years of experience in both the private and public sectors and over 19 years of experience as a corporate director.

By Reena Aggarwal

The Past and Future of Corporate Governance Research

“But if governance is important for firm performance, then we need to address a number of follow-up questions. For example, how do we measure good governance? Why does governance matter? What aspects of governance matter under what institutional settings?”

Over the past 25 years, interest in corporate governance has grown substantially among market participants, policy-makers, and academics. Corporate scandals such as Enron and WorldCom and the financial crisis of 2008 are perceived to be at least partially driven by failures in corporate governance. Sound corporate governance mechanisms can be mandated by legislation such as the Sarbanes-Oxley Act of 2002 and the Dodd-Frank legislation of 2010 in the United States, while in other countries they have come in the form of codes of conduct. In addition to mandated regulation, the firm itself and market participants, particularly institutional investors, play an important role in the governance structure of firms.

Corporate governance research has been interdisciplinary, using varying perspectives by calling on scholars from several fields, including law, economics, finance, accounting, and management, to examine the issues. In the 1990s, governance research was driven by scholars in law and finance, and focused on various aspects of legal and institutional features at the country level. Many influential studies have examined the cross-country differences between countries with different legal systems and shareholder rights, and have found that strong investor protection is associated with countries with higher economic growth and more developed financial markets. At that stage of research, we knew very little about governance at the firm level. However, in the last 10 years, academic research has closely examined not only the effect of governance mandated by a country’s rules and regulations, but also the governance mechanisms that firms have adopted voluntarily.

THE IMPORTANCE OF CORPORATE GOVERNANCE

It took a few years for academia to establish that corporate governance does matter for firms and markets. Researchers have found that corporate governance is related to firm performance, access to capital, cost of capital, and other aspects of a firm that impact value. But if governance is important for firm performance, then we need to address a number of follow-up questions. For example, how do we measure good governance? Why does governance matter? What aspects of governance matter under what institutional settings?

ROLE OF BOARDS OF DIRECTORS

Studies have examined organizational structures of boards, such as board size, independence, the election process, meeting attendance, member expertise, and board compensation structures. Recently research has focused on board functions and their specific outcomes. For example, studies find that a larger proportion of independent board members is associated with higher firm value, higher turnover of poorly performing CEOs, and more responsible management compensation policies. Although current research shows that boards of directors play a critical role in the governance of firms, there is still much analysis that needs to be done. What factors make for an effective board? What is the importance of a board’s composition, expertise, and incentive structure on firms?

EXECUTIVE COMPENSATION

Financial economists have written extensively about the important role of the incentives a firm uses to align management’s interest with that of shareholders. Shareholders and regulators have been outraged by the fact that executives continue to receive excessive compensation even as the firms they manage teetered on the brink of disaster. Regulators around the world have either imposed or are considering imposing restrictions on executive compensation. Academic research has led to major changes in corporate compensation practices in the past. Scholars are currently examining issues related to clawback provisions and “say on pay” in management’s decision making. The recent financial crisis has highlighted the need for further research on designing compensation structures that will align management compensation with sustainable long-term firm performance.

ROLE OF SHAREHOLDERS

Several studies have documented the strong connection between institutional ownership and corporate governance. More recently, my own work has found that an increase in institutional ownership is associated with an increase in corporate governance. We also show that institutions are taking their fiduciary role seriously; more and more often they are exercising their right to vote rather than simply exiting from the investment.



An MSCI Brand

“The approach to evaluating governance has mostly taken a one-size-fits-all approach, which is not the most effective practice to follow. There should be some diversity in governance practices across firms, and both regulators and researchers must take into account the differences in managerial and institutional structures.”

New types of institutional investors, such as private equity firms, hedge funds, and sovereign wealth funds, have emerged and their roles have become the subject of academic studies. Scholars in law and finance are looking into concerns about the so-called “empty voting” that some market participants accomplish by using derivatives and using the securities lending market. Although regulators have given shareholders more rights, some market participants are concerned that certain types of shareholders will use the new rights only for their own short-term benefit. Researchers still need to do much more to guide the policy debate on the extent to which shareholders should be given additional rights. The key questions in this area are to what extent should shareholders delegate powers to the board, and when is direct shareholder activism needed? Will shareholders use the given rights for their own short-term gains? What can we learn from the differences in voting rights and proxy voting mechanisms in different countries?

THE ONE-SIZE-FITS-ALL APPROACH TO GOVERNANCE

The approach to evaluating governance has mostly taken a one-size-fits-all approach, which is not the most effective practice to follow. There should be some diversity in governance practices across firms, and both regulators and researchers must take into account the differences in managerial and institutional structures.

Initially, academic studies used an equally weighted index of several governance attributes as a proxy for good governance. But certainly the same index is not appropriate for all types of firms around the world. Academics are aware of this shortcoming, but there is little theoretical guidance toward an “optimal” model of corporate governance.

One of the more challenging areas in corporate governance research is to increase understanding of the optimal governance practices that allow for

local, industry, institutional, and other differences. Future research must address what combination of governance mechanisms is important for particular types of firms. This research will be important for policy-making and will move us away from the one-size-fits-all approach to regulation.

GLOBAL IN NATURE

Financial markets are global in scope; firms have the option to raise capital in different countries and investors can make investments anywhere in the world. Capital seekers and capital providers export governance from one country to another. Academic research has reported a convergence in governance standards across countries. There are “best practices” in governance that apply for most large firms, and these policies have led to the development of codes of good governance. Research, including mine, indicates that the market rewards firms for investing in good governance. It is only natural that governance research be global in nature, and that it should have both a macro and a micro focus.

FUTURE OF CORPORATE GOVERNANCE RESEARCH

The financial crisis has clearly proven that we are far from aligning the interests of investors, managers, directors, corporations, and society. We have yet to achieve consensus on what is good governance, how to measure it, how to achieve it, and what is the outcome of good governance. Research in corporate governance has made great progress, and our understanding of governance mechanisms and their impact has improved considerably. But the fact is that the research is still in its infancy. I believe that academic research will continue to play an important role in examining governance issues in a comprehensive, rigorous, and unbiased manner. Our analysis will help guide policy-makers and drive market practices, resulting in strong global financial markets that can be trusted by the public.



An MSCI Brand



About the Author

Reena Aggarwal is the Robert E. McDonough Professor of Business Administration and Professor of Finance at Georgetown University.

By Tim Smith and
Carly Greenberg

“The majority of S&P 500 companies now publicly declare their commitment to act as responsible corporations and do some sort of CSR or sustainability reporting.”

Corporate Commitment to Sustainability and CSR Reporting: An Enduring Trend

In the last 25 years there have been countless, notable changes in governance policies and practices by corporations. These changes mirror a shift in thinking and behavior by companies and investors where both attitudes and actual behavior have changed dramatically since 1985.

One remarkable change for both investors and companies has been the rapidly expanding support for corporate social responsibility (CSR) leadership, as well as sustainability reporting.

The majority of S&P 500 companies now publicly declare their commitment to act as responsible corporations and do some sort of CSR or sustainability reporting. Similarly, there is a surge of commitment by global investors who integrate Environmental, Social, and Governance (ESG) issues into the investment process and support meaningful transparency and business leadership in CSR.

The expansion of company CSR work and reporting is global and growing. In 2008, the consulting group KPMG reported that 79 percent of the largest 250 global companies produce CSR reports. Overall support for this trend is growing in all industries and countries, while the level of importance placed on CSR depends on the company’s individual industry and geographic location. A new Accenture study titled, “A New Era of Sustainability: UN Global Compact-Accenture CEO Study 2010,” shows that companies involved in the Automotive, Banking, Mining, Energy, and Utilities industries see sustainability issues as very important compared to companies in the communications and IT fields.

The business case for CSR leadership and sustainability is multifaceted. Some compelling points are summarized below.

DECREASE REGULATORY AND LITIGATION RISKS

The business world is changing. “All companies face a direct impact from decreasing natural resources, rising populations, and disruption from climate change. And what may be a subtle effect now will only become more intense over the next five to ten years,” according to Mark Parker, CEO of Nike.

Meanwhile, these global challenges are already

stimulating new legislation and future regulations. Companies that are committed to CSR are likely better equipped to face such challenges. For example, a company that is already monitoring and setting goals to reduce its carbon emissions will be ahead of the crowd when carbon pricing becomes the regulatory norm.

And, as we know “what is measured is managed.” A commitment to CSR reporting can help decrease a company’s general business risks. A management committed to in depth reporting will know which ESG operations need improvement and take the necessary measures to do so, reducing possible liability. Conversely, ignoring these risks enhances the possibility that a company will face an ESG related legal or regulatory risk.

AVOID REPUTATIONAL RISK AND BUILD PUBLIC TRUST

In light of the recent economic meltdown, public trust in business has substantially declined. The 2009 Edelman Trust Barometer reported that American trust in corporations declined from 58 percent in 2008 to 38 percent in 2009. Trust is a crucial factor for future long-term business prosperity considering many consumers make purchasing decisions based on their perception of company trustworthiness. According to Accenture, “in 2008, 91 percent of consumers said they had bought a product or service from a company they trusted, whereas 77 percent had refused to buy a product or service from a distrusted company.” Accenture also states that “sustainability has long been viewed as one of many elements in companies’ strategies to build their market reputation.” A commitment to CSR reporting can help prove to stakeholders and consumers that a company is accountable and trustworthy. The Dell 2009 Corporate Responsibility Report highlights this stating, “during times like these, we must continue to build trust with customers and stakeholders by demonstrating our positive impact on society and the planet and developing meaningful measures for reporting our progress.”

OPPORTUNITIES TO REDUCE COSTS AND ENHANCE REVENUE

Many companies have already found multiple ways to cut operational costs utilizing their sustainability



An MSCI Brand

programs as a guide. For example, Apple reduced packaging for their computers. This initiative enabled them to fit more products into a cargo hold and reduce waste, transportation, and fuel costs by using fewer shipment carriers while still shipping the same number of computers. Other companies have been able to save costs by exploring new materials for their products, improving energy efficiency at facilities, and by enhancing workforce safety programs.

Leadership in CSR can also improve a company's efficiency, productivity, competitive edge, long-term survival, and ability to attract labor, investors, and consumers. CSR Reporting also helps companies better integrate and gain strategic value from existing sustainability efforts, and identify gaps and opportunities to enhance their revenue in their operations.

The number of companies that provide sustainability reporting is increasing. Therefore, if a company does not do CSR reporting, it is highly likely that its competitors are and that it is lagging behind its peers.

"The number of investors and dollars that publicly support the PRI principles is growing at a rapid rate."

ADVANTAGES IN RECRUITING LABOR

A company that understands CSR issues and discloses its safety practices, non-discrimination policy, worker benefits, etc., will be seen as a good employer and be better able to compete for top talent in its industry. Interestingly, sustainability is also already becoming an important concern for prospective workers. A European banking CEO told Accenture that, "a survey of graduates seeking employment in two of the company's key markets cited performance on sustainability issues as the most important factor in helping them choose a potential employer." Additionally, companies with appreciative employees have less employee turnover and can save new-hire training costs.

ADVANTAGES IN BEING RESPONSIVE TO ESG INVESTORS

According to the Principles for Responsible Investment (PRI), "there is increasing evidence that ESG issues can be material to performance of portfolios, particularly over the long term." Increased savings and profit derived from corporate sustainability will obviously result in better shareholder returns. Moreover, for the long-term investor, a company with a forward-looking view on managing sustainability issues is encouraging.

The number of investors and dollars that publicly support the PRI principles is growing at a rapid rate. Recently support for the PRI grew from 362 signatories and \$14.778 trillion in 2008 to 785 signatories and approximately \$20 trillion in 2010. As support for PRI and its principles grow, it will be advantageous for companies to improve their sustainability initiatives and transparency. It is also notable that many mainstream financial institutions such as Goldman Sachs and JP Morgan currently acknowledge the importance of ESG to investments.

More and more companies are urging their suppliers to meet high standards in ESG. Supply-chain guidelines often include requiring suppliers to meet specified environmental, social, and governance performance levels or strongly encouraging them to publish a CSR report. As this trend develops, it is likely that many companies will begin to face pressure to do CSR reporting from their corporate customers.

In summary, one of the remarkable changes in the last quarter century has been the considerable growth of commitment by corporations to CSR and sustainability reporting. There are many reasons for companies to move in this direction, but the bottom line is that it is good for business.

Here are some quotes from corporate leaders that illustrate this view:

"Our approach has created value not only for our stakeholders and society, but also for Intel"

—Paul S. Otellini, President and CEO of Intel

"It is our view that successful companies are those that see business objectives and sustainability objectives as interlinked"

—ExxonMobil's 2009 Corporate Citizenship Report

"We also know that the successful companies of the 21st century will be those that understand global sustainability issues and offer viable solutions."

—Alan Mulally, President and CEO of Ford Motor

"Good things happen when we integrate sustainability into our products, services and solutions. We improve our competitiveness and create and capture customer value. We save money, reduce our environmental impact and improve employee satisfaction."

—Jim Owens, Chairman and CEO of Caterpillar



An MSCI Brand



About the Author

Tim Smith is a senior vice president at Walden Asset Management, and Carly Greenberg is a Walden summer associate and a student at Brandeis University.

An Interview with
Nell Minow

A Look Ahead at the Next 25 Years in Governance

“Board composition is what matters, and that will include the ability of shareholders to vote directors off the board through majority vote requirements and proxy access.”

Over the past 25 years, there’s been a significant shift in how institutional investors have handled their responsibilities as shareholders, and how boards have exercised their oversight over executives. Do you expect that these trends will continue over the next 25 years, or will the pace of these trends become more gradual?

The pace has been accelerating, and I think it will continue to accelerate. As the upheavals of the first decade of the 21st century have shown, governments are really at a loss when it comes to imposing any kind of accountability on corporate executives, and it really is increasingly clear that it’s left to the shareholders. As it becomes easier and more routine for shareholders around the world to be in touch with each other on these issues, the pace will continue to accelerate.

Do you expect to see a growing convergence in governance standards across international markets? “Say on pay” is one example where that appears to be happening.

It’s hard to say right now whether it’s going to be a “race to the bottom” or a “race to the top.” But certainly, the emerging economies are watching carefully so that they don’t repeat the mistakes of the established economies. And I think it’s really going to be a cost-of-capital issue, and that whoever has the best governance system is going to have the lowest cost of capital. So there will be some convergence, but there will be some competition as well.

Over the next 25 years, what types of governance issues do you expect to be the most significant points of contention between investors and issuers? Will the most contentious issues relate to board independence, shareholder nominations to the board, takeover defenses, or executive compensation.

I would list them in this order: board composition, No.1; executive compensation, No. 2; and everything else, No. 3. In that “everything else” category, in addition to the items that you listed, I would include political contributions.

I don’t use the term board independence, because I don’t believe in what I call “resume independence.” I think that there is no such thing as independence

as long as the executives control who is on the board. I think board composition is what matters, and that will include the ability of shareholders to vote directors off the board through majority vote requirements and proxy access.

With the arrival of “say on pay” votes as a marketwide requirement in the United States, do you expect any meaningful changes on how companies compensate their executives, or will the pay-setting process continue to be driven by executives and management-hired consultants, with investors and board members largely playing a passive or reactive role?

The only way to address executive compensation is to get rid of compensation committee members who do it badly. Every time I get interviewed about executive compensation, which is a couple of times a week, and a couple of times a day during proxy season, I always ask the journalist: Could you please put the names of the compensation committee members in the story? I’ve been very unsuccessful in that, but I’m going to keep it up, and I think it is going to change. I think that you have to make it very personal. You’ve got to get rid of compensation committee members who do it badly. I think “say on pay” is nice, but that’s the only thing that’s really going to be meaningful.

Do you expect that retail investors will play a greater role in shaping corporate governance over the next 25 years or will most of them continue to be passive or just support management most of the time?

I think retail investors as a group are going to shrink, but I think their influence is going to grow. A few retail investors have been scared off by the volatility of the markets, and who can blame them? I would never tell somebody as an individual to be a stock picker unless they are really good and make it their full time job. What I often say is you’re not going to play basketball against Michael Jordan for money. They’re betting that they can do better than the professionals.

However, I think that those investors who are vitally engaged enough to be stock pickers and who are not just day traders, but who make a meaningful commitment, will take advantage of the opportunities



An MSCI Brand

that are available on Yahoo message boards and Motley Fool.com to become more actively involved. I think that there are a lot of large institutional investors out there who will follow. They won't be leaders, but they will follow an outspoken activist.

Do you expect an increase in retail shareholder activism?

I do think that there will be. I look at Motley Fool, which speaks to retail investors, and, retail stock-picking investors, and they're very sophisticated about these issues, and I think that people who follow them and who rely on them will become more involved. And there are also groups like MoxyVote.com and the Shareholders Education Network that will make it easier for individual investors who don't want to be active to at least be more intelligent and thoughtful about the way they vote.

While the prospects for new governance legislation appear unlikely after the Republican takeover over of the U.S. House, what governance issues should be addressed by federal legislation over the next 25 years?

I think we will see some increasing steps away from federalism. Proxy access is a good example, and I expect proxy access to be upheld, or if it is dismissed on technical grounds, it can be reinstated easily. I think that Delaware will play less of a role, and more of corporate governance will be a matter of federal law.

Are there certain governance issues that should be left to private ordering, such as independent board chairs, or should the government or take a greater role in mandating certain minimum standards?

"The only way to address executive compensation is to get rid of compensation committee members who do it badly."

I'm a big fan of the "comply or explain" approach, which imposes minimum standards and encourages particularity and innovation. I advocate that we establish a base set of standards with strong incentives to exceed it in a manner that is appropriate on a company-by-company basis.

Private ordering is not enough currently because of the inadequacy of shareholder powers. Delaware law allows for private ordering of proxy access, and yet not one company has adopted it because it's more theoretical than real. At the same time, there are academics out there, and I presume lawyers in private practice, who are already circulating memos saying here are the ways to circumvent [the SEC's] proxy access [rule]. They use terms like "circumvent" and "thwart," which are obstructive. Why don't they circulate memos saying here's the way to get the most out of it? It always strikes me as absurd that the very same companies that talk about the purity of the marketplace don't want to submit their directors to a market test, or their corporate governance policies to a market test.

Besides the long list of Dodd-Frank-related rulemakings that are underway, are there any other investor production issues that you think the SEC should be addressing?

I think they've got a very full plate for right now, so let's see how those shake out. For me, the No. 1 priority for shareholders should be majority voting [in board elections]. I think it's really important that shareholders throw some directors out, and I think that will have a salutatory affect on everybody else.



An MSCI Brand



About the Author

Nell Minow is a co-founder of The Corporate Library. Minow also was one of the founders of ISS and served as president of the company. She also served as a principal at LENS Investment Management.



An MSCI Brand



An MSCI Brand

This report is provided by Institutional Shareholder Services Inc. ("ISS"), an indirect wholly-owned subsidiary of MSCI Inc. ("MSCI"). MSCI is a publicly traded company on the NYSE (Ticker: MSCI). As such, MSCI is not generally aware of whom its stockholders are at any given point in time. ISS has, however, established policies and procedures to restrict the involvement of any of MSCI's non-employee stockholders, their affiliates and board members in the content of ISS' reports. Neither MSCI's non-employee stockholders, their affiliates nor MSCI's non-management board members are informed of the contents of any of ISS reports prior to their publication or dissemination.

Issuers mentioned in this document may have purchased self-assessment tools and publications from ISS Corporate Services, Inc. ("ICS"), a wholly-owned subsidiary of ISS, or ICS may have provided advisory or analytical services to the issuer. No employee of ICS played a role in the preparation of this document. Any issuer that is mentioned in this document may be a client of ISS, ICS, ISS' parent company, MSCI Inc., or a subsidiary of MSCI Inc., or may be the parent of, or affiliated with, a client of ISS, ICS, MSCI Inc., or another MSCI Inc. subsidiary. If you are an ISS institutional client, you may inquire about any issuer's use of products and services from ICS by emailing disclosure@msci.com.

This document and all of the information contained in it, including without limitation all text, data, graphs, charts (collectively, the "Information") is the property of ISS, its subsidiaries, or in some cases third party suppliers. The Information may not be reproduced or disseminated in whole or in part without prior written permission of ISS.

The Information has not been submitted to, nor received approval from, the United States Securities and Exchange Commission or any other regulatory body. None of the Information constitutes an offer to sell (or a solicitation of an offer to buy), or a promotion or recommendation of, any security, financial product or other investment vehicle or any trading strategy, and ISS does not endorse, approve or otherwise express any opinion regarding any issuer, securities, financial products or instruments or trading strategies.

The user of the Information assumes the entire risk of any use it may make or permit to be made of the Information.

ISS MAKES NO EXPRESS OR IMPLIED WARRANTIES OR REPRESENTATIONS WITH RESPECT TO THE INFORMATION AND EXPRESSLY DISCLAIMS ALL IMPLIED WARRANTIES (INCLUDING, WITHOUT LIMITATION, ANY IMPLIED WARRANTIES OF ORIGINALITY, ACCURACY, TIMELINESS, NON-INFRINGEMENT, COMPLETENESS, MERCHANTABILITY AND FITNESS FOR A PARTICULAR PURPOSE) WITH RESPECT TO ANY OF THE INFORMATION.

Without limiting any of the foregoing and to the maximum extent permitted by law, in no event shall ISS have any liability regarding any of the Information for any direct, indirect, special, punitive, consequential (including lost profits) or any other damages even if notified of the possibility of such damages. The foregoing shall not exclude or limit any liability that may not by applicable law be excluded or limited.



An MSCI Brand