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SPECIAL 15TH ANNIVERSARY ISSUE

A Celebration of 15 Years: Thoughts from the Corporate Governance Leaders

We asked our Board of Advisors to give us their thoughts on the journey that corporate governance has taken—and where it might be headed—to celebrate fifteen years of existence.

CONTENTS

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A Celebration of 15 Years: Thoughts from the Corporate Governance Leaders 1

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A Struggle for the Soul of the Board

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The 15th anniversary of the *Corporate Governance Advisor* finds the governance movement at a critical turning point, providing a suitable occasion to consider the consequences of reform and the challenges that remain.

Have two decades of shareholder activism and governance reform helped or hurt US corporations? No less an authority than attorney Martin Lipton believes that companies and boards have been hurt. He characterizes the governance movement as a power struggle to "wrest control from boards" and warns that "shareholder activism is ripping through the boardrooms of public corporations and threatening the future of American business."[1]

However, what Mr. Lipton sees as a "forced migration from director-centric governance to shareholder-centric governance" is perceived differently by investors and governance advocates. Governance reform has indeed been a power struggle, but it has been between shareholders and executive managers, not directors. The actual governance migration has been from management-centric to board-centric. The struggle has been not for control of the company, but for the soul of the board.

The development of governance standards over the past 20 years has not weakened boards, it has empowered them. Governance has redefined the role of directors, strengthened their independence and authority, clarified their duties of care and loyalty and imposed higher standards of good faith, diligence and accountability.

Corporate governance reforms are here to stay. Over the next decade we can anticipate the following developments:

1. **Further amplification of the board's role, duties and compensation.** Directors are being asked to work harder, combining both their traditional strategic advisory responsibilities with new oversight and monitoring duties. Increases in director compensation are likely to follow.

2. **A comprehensive reconsideration of financial reporting and the audit.** Corporate scandals,

financial restatements and SOX 404 requirements have raised concerns about the usefulness of financial reports and the purpose of the audit. A healthy debate has begun, questioning how well financial disclosures serve the investing public, whether more forward-looking information (not forecasts) should be provided, whether the audit should do qualitatively more than affirm compliance with accounting rules, whether uniform global accounting standards should be embraced.[2]

3. **Collaborative, market-based solutions to the governance issues of the day.** Recently, supporters of the majority vote standard in director elections achieved a market-based solution by working collaboratively rather than promoting regulation. The lesson has not been lost. Institutional investors and issuers are seeking common ground and working together to analyze the legal and practical implications of today's most pressing governance issues: (i) improved quality in compensation disclosure; (ii) advisory votes on executive compensation; (iii) access to the management proxy for shareholder-designated board candidates; (iv) reform of shareholder communications and proxy voting mechanics; (v) promotion of global corporate governance standards and cross-border voting protections; (vi) transparency in stock lending, empty voting and the governance impact of hedging and derivative trading strategies; (vii) reduction of regulatory costs; (viii) use of technology in disclosure and communications; (ix) alleviation of short-term investment and business focus; (x) maintaining financial market efficiency and competitiveness.

The clearest definition of corporate governance is: *the proper allocation of power among the shareholders, the board and the management of a corporation.* Depicting these three power bases graphically in the form of the proverbial corporate governance triangle, the ideal well-governed company should achieve the form of an equilateral triangle with the board equidistant from both shareholders and managers and thus able to fairly mediate their conflicting but equally valid demands. By contrast, the poorly-governed company appears as a scalene triangle, usually with the board and management closely aligned and the shareholders far distant at an angle of substantially less than 60 degrees.

It appears that the scandals, legislation and reforms of the past 20 years have now reached a critical point, bringing the governance of US companies close to the desired equilateral configuration. To make the most of this adjustment and maintain the proper allocation of power, directors must be supported in their expanded role as independent monitors, mediators and strategic advisors. Here is some advice for both companies and investors to help achieve this goal:

1. **Companies**—Clean your own house, recognizing that the most intrusive governance reforms have been adopted in response to corporate misdeeds, excesses and fraud. Don't treat shareholders as the enemy, treat them as customers and owners.

2. **Investors**—Clean your own house, acknowledging the responsibilities of ownership and giving consideration to whether the governance standards imposed on portfolio companies are applicable to you as well. Don't micromanage companies' business decisions or dampen their entrepreneurial risk-taking.

3. **Companies and Investors**—Engage and communicate, but avoid rhetoric. Seek common ground on issues of concern to both. Work collaboratively to find market-based solutions rather than regulation. Pick a fight only as a last resort.

Notes

1. "Shareholder Activism and the 'Eclipse of the Public Corporation'," keynote address by Martin Lipton to the 25th Annual Institute on Federal Securities, Miami, Florida, February 7, 2007. (Available at *publications@wlrk.com.*)

2. *See* transcript of the meeting on the "Survey of Opinion on Financial Reporting and Auditing," sponsored by the International Corporate Governance Network and the Global Public Policy Committee and hosted by the Institute of Chartered Accountants in England and Wales, London, March 5, 2007. (To be available at *www.icgn.org.*)