

Corporate Governance Commentary

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A 12-Step Program to Truly Good Corporate Governance

Highlights

Good corporate governance is an admirable, but elusive, goal. Everyone is in favor of it, but there is far from universal agreement about what it is and how to get there. This *Corporate Governance Commentary* offers a 12-Step Program to what we believe would be truly good corporate governance.

1. Start at the beginning — the principal, if not exclusive, goal of corporate governance should be to enhance value creation for shareholders.
2. Recognize that most corporate governance analogies to political, economic or legal theory are rhetorical devices, not answers.
3. Don't base corporate governance policies solely on Adolf Berle's and Gardiner Means's concerns about the separation of shareholders and corporate managers.
4. Don't get caught up in a debate between short term and long term strategy and execution.
5. Affirm the board's primary role as strategic advisor to and supervisor of management, not as enforcer of regulatory and legal requirements and preventer of agency costs.
6. Limit a board's size to enhance its effectiveness.
7. Select nominees for directors for their key competencies, even at the cost of some degree of independence.
8. Select a board leadership structure that works in the context of a particular board and management team.
9. Do not fall prey to calls for frequent shareholder votes in the name of accountability.
10. Remove the clutter of shareholder proposals from the annual meeting agenda.
11. Reformulate the fiduciary duty of investment advisers with respect to voting portfolio shares.
12. Recognize that investors voting with their feet is a far more efficient discipline for corporate managers than corporate governance theories, which are unproven as generators of economic value.

Introduction

Good corporate governance is of the moment. It is talked and written about constantly by academics, the corporate governance community working for institutional investors and proxy advisors, boards of directors, corporate executives, corporate lawyers, judges, reporters and, yes, even politicians. Indeed, it is talked about and written about so often and at such length that it often seems to tower above all other aspects of the corporate world. The discourse, moreover, has come to resemble something of a Tower of Babel, where so much is said, from so many points of view, that it seems impossible to make sense of it all.

This essay attempts to bring some coherence to the topic by positing a 12-Step Program that we believe would lead to a useful and effective paradigm for truly good corporate governance.

Step One: Start at the Beginning — The Proper Goal of Corporate Governance is to Enhance Value Creation for Shareholders

The literature and lore of corporate governance has become so complex and complicated that most of us tackle corporate governance issues on a relatively detailed level. We too often deal with the proverbial trees, not the proverbial forest. For example, we debate ad nauseam the merits of proxy access, or the optimum frequency of say-on-pay advisory votes or the utility of say-on-pay advisory votes. We worry about whether directors should be selected by majority voting instead of plurality voting, and how to frame a director resignation policy to deal with directors who fail to receive a majority vote under either system. We wrangle about whether poison pills should ever be allowed, and if so, whether they should be restricted to a one- or three-year term, and which body — directors or shareholders — should have the power to make these decisions. And participants in these and all of the other corporate governance discussions commonly assume that whatever seems to them to be the right answer to any given governance issue at any one time is the right answer for all companies, regardless of their particular circumstances.

It's pretty hard to come to grips with the fundamentals, however, if you spend all of your time with the details. So the simple, but critical, first step in our 12-Step Program for truly good corporate governance is to start from the beginning.

What is the beginning? We believe it is the very simple principle that a corporation is an organization, created by law, having as its goal the creation of economic value. In a capitalistic, free market economic system, value creation accretes first and foremost to the corporation's equity holders. In other systems, it accretes to other constituencies, such as workers or the government. Since the US is at bottom a capitalistic, free market society, the wealth created by US corporations belongs principally, many would say exclusively, to shareholders. We believe history has shown that adherence to this principle offers the best prospects for general prosperity and the wherewithal to fund governmental and private sector social responsibility programs and initiatives. The 12-Step Program outlined in this essay begins with this simple, fundamental assumption.

“Start at the beginning — the principal, if not exclusive, goal of corporate governance should be to enhance value creation for shareholders.”

It continues with the obvious corollary that good corporate governance is not important for its own sake. The point of good corporate governance is to enhance the value creation capabilities of corporate enterprise. Corporate governance is not a lesson in civics or political theory. It is a search for a governance structure that will enhance the economic value generation of the corporate form of business enterprise.

Step Two: Recognize That Most Analogies to Political, Economic or Legal Theory are Rhetorical Devices, Not Answers

Too much of today's discussion about corporate governance is couched in, and often decided by, simple analogies. First and foremost is “shareholder democracy” — a nice sounding slogan, but hardly a useful principle for creating a system of corporate governance that will achieve the goal of creating economic wealth for shareholders. What, after all, does shareholder democracy mean? It connotes a right to vote, but on what matters and how often? Once a year for all directors? Not necessarily, since classified boards have been long recognized as a permissible structure for corporate governance and have often been associated with economic success. There is, moreover, nothing “undemocratic” about representative bodies whose members serve staggered terms — witness the US Senate. Nor is annual election a necessary hallmark of democracy, as both Houses of the US Congress demonstrate with their two- and six-year terms of office.

Similarly, shareholder democracy does not require that each share have one vote. For example, votes can be allocated to different classes of stock in proportion to their relative share of the corporation's residual economic pie. Doing so is hardly inconsistent with the notion of shareholder democracy, and may be more "democratic" than allocating votes among classes of stock without regard to their relative economic values.

Share ownership is not equivalent to citizenship (or any other basis for allocating votes in a polity); it is a way of allocating rights attaching to ownership of an economic instrument. A high vote/low vote differential among classes of common stock, for instance, is not undemocratic when viewed as a contractual bargain attaching to shares of the different classes. Investors who don't want to own a low vote class simply do not have to do so. Buying a low vote class is simply agreeing in advance to accept that contractual bargain as part of the investment decision. The contract is neither democratic nor undemocratic. In short, all the analogies in the corporate governance arena to political concepts and models remain just that — analogies, not statements of inherent right or wrong.¹

Another bromide of widespread currency today is that shareholders "own" the corporation. This may be true in some figurative senses, but it is not true legally or literally. Shareholders own shares in a corporation, which ownership confers on them only those rights specified by law and, under the enabling principles of state corporation statutes, the governing instruments of the corporation. Stock is effectively a derivative security, the value of which is measured by the market's judgment of worth of a collection of specified rights and obligations with respect to a legally created entity. Those rights typically include free transferability, specified voting rights with respect to election of directors and certain other matters and the right to receive a designated share of the residual value of the corporation following liquidation and payment of creditors and any superior classes of stock. This is not the same kind of ownership as fee simple title to a plot of land or ownership of an automobile or ownership of a book. To say that shareholders "own" the company and therefore have certain rights is to misstate the shareholders' relationship to the legal entity that constitutes the corporation and to confuse the discussion, rather than provide useful answers.

A third example of an overly simplistic analogy often used in corporate governance dialog is characterizing directors and management as "agents" of shareholders, thereby suggesting that management and directors are subject to all of the obligations and constraints that an agent bears to its principal as a matter of law. No one views the President of the US and the executive branch as "agents" of the citizens within the legal meaning of the term "agent." Nor do we think of our legislative representatives as our legal agents, bound to do our bidding as a legal agent is typically bound. It is equally fallacious to think of directors and management of a company as "agents" of the shareholders within the legal or literal meaning of that term. The relationship of management to directors and of both management and directors to shareholders is different from, and more complicated than, that of legal agent and principal.

Step Three: Don't Base Corporate Governance Policies Solely on Concerns About Separation of Shareholders and Corporate Managers

Adolf Berle and Gardiner Means are famously credited with a critical insight of the 1930s that the widely dispersed shareholder base of the (then) modern public company (in contrast to the earlier corporate paradigm, where a small number of large shareholders were directors and often managers) resulted in a separation of shareholders and management and the specter of unwarranted agency cost — that is, a management group that operates to a lesser or greater extent to maximize its interests at the potential or actual expense of the interests of shareholders.² While this insight was important and the dangers of agency cost remain real (although diminished), it cannot be the whole point of corporate governance. The literature and current practice of corporate governance is overly preoccupied with championing governance practices principally because they would or might deter potential agency costs. However, that a governance principle reduces the risk of agency cost does not, without more, make it a good governance principle. The relevant measure of a governance principle is whether its application will further the fundamental *raison d'être* of the public corporation — economic value creation.³

Viewing the potential leakage of value attributable to agency cost as the be-all-and-end-all of corporate governance is to confuse means and ends. With apologies for repetition, the purpose of corporate governance is to enhance value creation by the entity on an all-in basis. It is not to

preclude agency cost at the greater cost of inefficient management structures, preoccupation with exaggerated risks and net value destruction. Academic literature, which fails to evaluate proposed corporate governance policies in light of their ultimate impact, but only in the context of lessening or preventing agency cost, is neither sensible nor helpful.

Step Four: Don't Get Caught Up In a Debate Between Short Term and Long Term Strategy and Execution

Too much of the current discussion of corporate governance centers on a debate about whether boards and management should focus on short term actions to create shareholder value, or whether doing so risks or makes impossible longer term and more sustainable value creation.⁴ The problem with the debate is not that it is about unimportant issues — it is, after all, about the most fundamental issue of optimizing value creation for the benefit of stakeholders. The problem is that the debate is unrelated to the design of good corporate governance policies.

The investor community is deeply ambivalent about the long term, short term value creation debate. The actively managed investment advisory industry lives and dies by its performance statistics, which, in turn, are driven by investors' time horizons, be they monthly, quarterly or annual. While many advisers market longer term performance, few are successful if they consistently underperform their peers on a current basis. Index funds may also claim a long term viewpoint, but that claim is irrelevant because an index fund doesn't sell losers and buy winners based on a company's operations and strategy. Indeed, index funds make no pretense of studying the fundamentals of a company, stock-picking, market timing, momentum investing or using any of the other methodologies and investment styles used by actively managed funds. By hypothesis, they have and should have zero interest in whether a portfolio company engages in short or long term strategic planning.⁵

Moreover, while corporate governance policies may provide limited shelter to a management and board from the day-to-day vagaries of the market's prescriptions for value creation, they cannot insulate managers from those forces in the longer run. If investors are unhappy with a company's business strategy or financial performance, they vote first and foremost with their feet. To the extent that the pitter-patter of investors' feet in the market is not persuasive in the executive suite and board room, investors have further recourse in the form of activist investor agitation, proxy contests and takeovers. This, of course, is what the takeover contests pioneered in the 1960s and matured in the 1980s are about; this is why activist investors have been successful since the early 2000s in launching targeted campaigns to force major changes in corporate strategy. Classified boards, poison pills and the host of other takeover defenses have not stopped the market to date and will not be able to do so in the future.

As a practical matter, corporate governance structures, at most, can have only a marginal effect in insulating a board or management from the discipline of the market. If most investors in a stock want the company to pursue what management and the board believe to be a wrongly held short term strategy, and management and the board cannot change their investors' viewpoint, the investors will win the day. Conversely, if investors believe management is pursuing short term goals at the expense of more highly prized longer term value, investors will vote with their feet, agitate at the corporate ballot box or both. Victory for the investors may come quickly in terms of weeks or months, or more slowly in terms of years. But at the end of the day, if investors care enough, they will prevail, and the corporate governance structure of the company will not have a measurable affect on the timing of their victory.

The upshot is that corporate governance debates about annual election of the full board vs. staggered board, or about the permissibility and duration of a poison pill, or about whether and under what circumstances shareholders should be able to call a special meeting are not about long term value creation vs. short term value creation. Rather, they are about how, not whether and when, investors can make known their views on virtually any topic investors consider relevant or important, without regard to their value creation attributes.

Step Five: Affirm the Board's Primary Role as Strategic Advisor to and Supervisor of Management, Not as Enforcer of Regulatory and Legal Requirements and Preventer of Agency Costs

An overarching issue about governance of the modern public company is whether the board's principal function is to counsel with and advise management in the setting of corporate goals and strategy or to make sure management adheres to the straight and narrow in all things big and small. This debate is on-going and the two points of view are commonly associated with whether a participant is pro-management and favors a so-called "board-centric" philosophy of corporate governance, or pro-shareholder and favors a "shareholder-centric" philosophy. Two of the most frequent and visible participants in the debate are Marty Lipton, a champion of a board-centric model of corporate governance, and Lucian Bebchuk, a champion of a shareholder-centric model of corporate governance.⁶ It is well beyond the scope of this essay to analyze, even in summary, the pros and cons of the two positions. Suffice it for our purposes to make a simple observation and to draw from it a compelling conclusion.

The modern public company is typically a very large and complicated entity. The smallest company in the S&P 500 has a market capitalization of over \$4.0 billion. The complexity of managing companies of this size dwarfs the management issues faced by even the largest public companies of Berle's and Means's day. Management theory and practice are far more sophisticated than they were in the 1930s or 1940s or 1950s. Business models have increased in complexity along every axis from personnel management, to supply chain logistics, to sales and marketing methodologies. Along with size and complexity, companies have grown in their need for and execution of successful strategies in every area of their business. Understanding the business, operations and finances of a modern public company is far more challenging than ever before, if for no other reason than the explosion of available information and the increasing sophistication of management processes and policies.

By the same token, the legal and regulatory framework and requirements for a public company today are far more complex, technical and detailed than ever before. Sarbanes-Oxley famously imposed a host of new regulatory requirements on public companies, as did companion stock exchange rules and, more recently, the Dodd-Frank Act. Accounting principles (whether GAAP, which is now phasing out, or IFRS, which is now phasing in) and SEC disclosure requirements never get simpler, only more complicated and subject to more frequent amplification and revision.

Against this backdrop of complexity and information overload, the issue is simply that directors have only so much time and capacity to focus on and master the intricacies of their company's business and operations. Directors are not expected to be and are not compensated as full time, senior level management. Nor are they expected to spend full time on their duties.

The reality, obvious at least to us, is that directors simply do not have enough time, qua directors, to fulfill two competing principal roles. A board inevitably will focus either on a strategic and advisory role or on a policing role. It is neither fair, nor realistic, to expect a board to do both even at the smallest public companies. For this simple reason, call it human limitation or human nature, directors on a board need to march to a single piper.

Faced with this real world dilemma, we believe it is clear that to serve the essential function of a modern public company, a board, as a matter of truly good corporate governance, should mind the strategic and consulting store, not the regulatory store. The former is the road to economic value creation, the latter is not. Put another way, making strategic consulting and advice the principal board function should, if the board is effective, be a positive value creator. Protecting a company and its shareholders against regulatory failures so severe as to destroy value, while hardly unimportant, is at most only a way to avert value destruction in companies whose management either is not good enough to avert the problems without extensive and pre-occupying board intervention or is affirmatively corrupt. While these situations are hardly unknown, historically they have affected only a very small (albeit highly visible) percentage of public companies.⁷

Step Six: Limit Board Size to Enhance its Effectiveness

The size of a board of directors is a very important factor in its capacity to be effective. A number of studies have determined that a board of more than 9-11 persons starts losing effectiveness and, if much larger, becomes essentially ineffective, except as a rubber stamp for management initiatives.⁸ Accordingly, Step Six is simply to constrain board size to no more than 10, and at most 12, and to not be afraid of smaller boards, if they can meet requirements for mandatory minimum independence requirements.

Step Seven: Select Nominees for Director for Their Key Competencies, Even at the Cost of Some Degree of Independence

A corporate board should be composed of directors who have outstanding competencies in areas relevant to main aspects of the company's business and who can function collegially and effectively as a group. Nominees for directors should be selected for their competencies and ability to mesh with other directors. This is equally true for management candidates and shareholder nominees. Potential nominees who do not have strong competencies in areas critical to the particular company's business and economic value creation capabilities are simply not good candidates. Being nice and collegial is wonderful, but hardly enough to justify a candidacy. Having academic credentials, but no proven track record as a manager or active director in the private sector, is at best a gamble. Being supported by a particular shareholder constituency, in and of itself, is not much of a credential for contribution to the economic success of the enterprise. The simple reality is that every director should have the capability and motivation to contribute to the economic success of the enterprise. Every director who fails to meet this criterion is, at best, a wasted seat at a board table and a potential drain if board size is constrained for effectiveness of its decision-making capability.

One criterion for public company directors that has been increasingly elevated in importance and scope over the past 30 years is independence from management. This has resulted in public company boards, particularly of mid-sized and large public companies, consisting of all but one, or at most two, non-management directors. This trend, of course, was accelerated by Sarbanes-Oxley and related NYSE and NASD requirements for independent director composition of the audit, nominating and governance and compensation committees.

The push for independent director dominance on public company boards is now enshrined in the law and culture of public companies. Corporate governance activists commonly advocate independence standards far more stringent than those of Sarbanes-Oxley and the companion SEC and stock exchange rules. Unfortunately, the long-running drive for pristine independence of all directors except the CEO has obscured the case for having more than one management or former management director, so long as doing so doesn't threaten a board's ability to meet legally required independent director mandates for its committees.

A key factor, overlooked in the push for maximizing independence of directors from the company, is that modern public companies are very complicated enterprises, difficult to understand and even more difficult to know. If the only person in a board room with detailed knowledge of the company (and frequently its industry) is the CEO, the board inevitably will be at risk of becoming a prisoner of the CEO's expertise and his or her control of information flows from the enterprise. A board comprised of independent directors, with the exception of the CEO, may also find it difficult effectively to challenge the CEO's knowledge of and judgments on matters particular to the company.

The remedy for getting more company and industry expertise into the board room is to have former members of senior management of the company serve as directors, even at the expense of having a lower number of independent directors, and/or to recruit retired senior executives from other industry players. Either way, truly good corporate governance will often be better served by sacrificing some director independence for superior company and industry knowledge and competency.

Step Eight: Select a Board Leadership Structure that Works in the Context of a Particular Board and Management Team

The past several years have seen a great deal of time, effort and impassioned arguments on the part of corporate governance activists and others to convert US public companies to the familiar British and British-influenced board leadership structure, consisting of an independent, non-executive, and often full-time, chairman of the board, separate from the CEO. Failing adoption of a separate, independent chair, US public company boards have been pushed very hard to select an independent lead director as a formal part of their board leadership structure.

There is nothing wrong with either of these board leadership models, and a lot to be said in favor of them. The potential abuses inherent in having the CEO office combined with that of chairman of the board (particularly where there are no other directors on the board with knowledge of the company and its industry and the stature to challenge a strong CEO), are well known and need not be rehearsed. A corporate governance presumption strongly in favor of having an independent board chair or well-defined lead director role is a good default position.

However, good corporate governance is not like a recipe for a cake which, if followed, guarantees success and if not, promises nothing. Good corporate governance is not a one-size-fits-all prescription, regardless of the nature of the company and its business, its heritage and traditions and, most important, the personalities involved and their strengths and weaknesses. Not every CEO is an imperial CEO, running roughshod over management and the board and beyond counseling and criticism. Some are modest, collegial and relish consultation and advice. There are undoubtedly many CEOs and boards that would benefit from having a strong and wise independent non-executive chair, and many others that would benefit from having a well-defined lead directorship position. But there are surely other CEOs and boards where such board leadership structures are not needed as a practical matter or are too difficult to implement because of lack of candidates to perform the special leadership role.

The point is simple, and perhaps obvious. Board leadership is an art, not a science, and selection of wise and constructive board leaders even more of an art. High quality and qualified candidates for an independent chair role do not fall from trees. Picking a candidate who does not have the skill sets and cannot create the personal chemistry necessary to be a good, value added independent chair for a particular board and CEO combination may do far more damage than not having the office.

For these reasons, good corporate governance requires judgment about whether, at a specific point in time, a company would benefit from having an independent chair or formal lead director, and then acting only when the right candidate has been identified.

Step Nine: Do Not Fall Prey to Calls for Frequent Shareholder Votes in the Name of Accountability

Corporate governance activists like mantras. One of their latest and more successful mantras is that a small minority of shareholders (typically only 5 percent) should be able to call special meetings, and that shareholders should also have the right to act in writing by a majority vote. These governance proposals are based on the notion that boards and management should be “accountable” to shareholders more frequently than once a year at an annual meeting. If things “go wrong,” shareholders should be able to express their views (and impose their will) as soon as possible. This, after all, is a natural consequence of shareholders being the “owners” of the company. Moreover, because a board and management are “agents” of the shareholders, who are the “principals,” it’s wrong as a matter of good governance and against the concepts of shareholder democracy for shareholders to have to wait up to 12 months to be able to call its agents to account.⁹

These shareholder empowerment campaigns, of course, take shareholder democracy to the extremes of US political models in a handful of States (California being the most frequent exemplar) that permit citizen ballot initiatives and, perhaps, farther in that the corporate governance proposals would be available 365 days of the year. Moreover, while special meeting advocates usually recognize the desirability of requiring a minimum of at least 5 percent of all shares to call a meeting (similar in concept to requiring a specified number of voters to sign a petition for a ballot initiative), written majority consent advocates do not propose any minimum

share ownership to trigger a mandatory ballot. In their view, the owner of one share should be free to launch a written consent campaign on any topic and put the company to the time and effort of having to solicit in opposition, no matter how far fetched the idea or the likelihood of it obtaining a majority vote.

Whatever the merits of this version of democracy in the political world, it is difficult to see what economic value it can or would create in the corporate world. Shareholder meetings called by a relatively small percentage of outstanding shares, and written consent campaigns without share ownership minimums, are not prescriptions for truly good corporate governance. Rather they are simply paths for vocal minorities to distract management and directors from the meaningful issues at hand.

Step Ten: Remove the Clutter of Shareholder Proposals From the Annual Meeting Agenda

As a number of commentators have noted, shareholder proposals under Rule 14a-8 are not a creature of state law.¹⁰ Effectively, they are a creation of the SEC (with the assistance of the federal judiciary's broad interpretations of the rule¹¹), which has created a federal right to turn a shareholders' meeting into something like a town meeting with only limited (and increasingly diminishing) restrictions on matters that can be put to a vote by shareholders under the aegis of the rule.

Not only has the SEC created a broad shareholder right to place topics on the annual meeting agenda, it has made the qualifications to do so quite low (e.g., ownership of no more than \$2,000 worth of stock), it has consistently expanded the range of topics and breadth of proposals that are permitted under Rule 14a-8 and, in the eyes of many observers, it has consciously followed a policy of bending its interpretation of the rule in favor of shareholders, giving the proponents of shareholder proposals every benefit of every doubt, and some would say even more.

The result is that annual proxy season is increasingly about Rule 14a-8 governance proposals (more than 500 in 2010 for the S&P 1500)¹² and social responsibility proposals (more than 370 in 2010).¹³ There is real economic cost to the necessary pre-occupation of companies and governance and social responsibility activists with these proposals, not to mention the enormous diversion of SEC resources required to deal with the myriad of no action letters required for the SEC to perform its self-appointed role as referee of the Rule 14a-8 process.

What has the Rule 14a-8 process brought us? The list is relatively short, but very instructive.

- A major reduction in the number of in-force poison pills. This, however, is misleading, because companies are free to adopt a pill if they face or fear a relatively immediate threat, so the reduced number of pills in place is largely illusory.
- A major reduction in the number of classified boards, which may be good or bad depending on your viewpoint (particularly if a staggered board correlates with a longer term strategic and value creation viewpoint, as in theory it should).
- A significant move from plurality voting to majority voting for uncontested nominations for director,¹⁴ which is far more symbolic than real because of the director hold-over rule under state law and the dependence of both majority voting and plurality voting on a strong director resignation policy to put teeth into vote-no and withhold vote campaigns against directors.
- A large movement to re-configure executive compensation to the one-size-fits-all analysis of the two dominant proxy advisory firms. Making ISS and Glass Lewis the principal arbiters of executive compensation policies for many, perhaps most, US public companies hardly seems a good argument for Rule 14a-8, and is even harder to defend as a matter of truly good corporate governance or, for that matter, sound public policy.¹⁵
- A lot of sound and fury about social responsibility proposals, with very few proposals receiving enough votes to create sufficient traction to cause a change in company behavior.
- A tremendous increase in the power of corporate governance activists and proxy advisory firms, which is the truly significant consequence of Rule 14a-8.

Rule 14a-8, in reality, is nothing more or less than the principal means by which corporate governance activists (and, to a far lesser extent, social responsibility activists) achieve their goals.¹⁶ Do these goals enhance economic value for shareholders? The evidence is hardly conclusive.¹⁷ Do we need Rule 14a-8 for truly good corporate governance? Based on the record to date, it's hard to see why. Indeed, the record of the past 20 years outlined above indicates just the opposite.

Accordingly, we would advocate a significant reduction in the scope of Rule 14a-8 to limit it to matters on which shareholder votes are recognized by state law. This would intentionally preclude most of the precatory resolutions that are the bread and butter of the rule and would limit shareholders' ability to use the company proxy materials to matters on which shareholders can cast votes binding on their companies under state law and the company's governing documents. It would eliminate the town meeting aspects of the annual meeting, except where a company affirmatively chooses to open its annual meeting to precatory voting.

Step Eleven: Release Public Companies From the Straitjacket of One-Size-Fits-All Governance Policies and Metrics

We have suggested in two of our earlier *Corporate Governance Commentaries*¹⁸ that:

- Investment decision making and voting decision making have become unduly separated at far too many institutional investors, leading to excessive influence of corporate governance theoreticians at institutional investors and outsourcing of too many voting recommendations and decisions to proxy advisory firms.
- A proliferation of one-size-fits-all governance models and metrics has resulted that is disconnected from the particular circumstances and economic performance of public companies.
- The rigidity of corporate governance theory, as practiced by many institutional shareholders, is compounded (and perhaps also caused) by the large number of voting decisions each institutional investor feels compelled to make under a widely prevailing belief that an investment adviser's fiduciary duty compels it to vote every portfolio share on every matter in accordance with an independent analysis of the merits of the vote.

More recently, we published a *Corporate Governance Commentary*¹⁹ recommending that the fiduciary duty of investment advisers to vote portfolio shares be reformulated to provide that each investment adviser would be free to make the decision whether or not to vote, as well as how to vote, based solely on a cost/benefit analysis that concluded the vote would create more value than cost.

Among the benefits of the reformulation of the investment advisers' duty to vote would be a lessening of the leverage currently wielded by corporate governance activists and the proxy advisory firms. The reformulation would free institutional investors from the tyranny of having to vote on every issue in accordance with a corporate governance generated analysis and would permit them to decide not to vote on certain issues as a matter of policy or, if they so concluded, to vote in favor of management's recommendations except where they believed it would be counter-productive economically to do so. If the burden of needing to analyze the issues involved in every shareholder vote were eliminated, there would be far less need for internal governance staffs to establish and maintain comprehensive one-size-fits-all voting policies to avoid the economic burden of having to analyze de novo too many issues for too many companies each proxy season. By the same token, the proxy advisory industry's role in avoiding this economic burden would be lessened, as would the dependence of the institutional investor community on the proxy advisors' low cost, albeit low quality, research and recommendation services.

The reformulation of investment advisers' fiduciary duties would go hand-in-hand with our proposed reduction in the scope of Rule 14a-8. Combined, they would enable management and boards to pay far more attention to the real store — company performance and strategy — not one-size-fits-all corporate governance theories and metrics that today dominate the proxy season and an increasing amount of the rest of the year.²⁰

Step Twelve: Recognize That Investors Voting With Their Feet Is a Far More Efficient Discipline for Under-Performing Managements than Imposition of One-Size-Fits-All Corporate Governance Theories Which Are Unproven Creators of Economic Value

Corporate governance activism is frequently justified by assertions that the hoary Wall Street adage that “investors vote with their feet” is no longer apposite and that a widely dispersed shareholder community, even one dominated by institutional investors, cannot effectively discipline bad managers and bad managerial decisions by their portfolio decisions. The only alternative, according to this view, is for investors to insist on good corporate governance to prevent or correct for bad managers and bad management. Underlying this argument are the premises that:

- At least larger actively managed funds have to stay invested in many stocks because their positions are either too large to liquidate rapidly and/or they must maintain a portfolio position in certain key companies (e.g., GE, IBM, Google), regardless of management quality and operating performance and
- Index funds (and certain other types quantitatively managed funds) must stay invested in all companies represented in their quantitative model, without regard to quality of management and operating results.

The fallacy in the view that many actively managed funds are too large effectively “to vote with their feet” is that it ignores the pricing impact of sales of even a portion of a portfolio position by a fund. If there is a prevailing view among active money managers that a company is being poorly managed, there will be net selling of the stock and a decline in its price. Total liquidation of portfolios is not necessary to send a meaningful message from the market. Managers today receive significant amounts of their remuneration in the form of company stock. If the stock consistently fails to perform and loses value, managers lose money and the expectation of money, whether they are compensated in stock options, restricted stock, or stock-price based cash programs. If neither management nor the board of an under performing company “gets it,” the stock will continue to languish as certainly as water will seek its own level.²¹

It is hard to believe that a board and management that benighted would respond better to corporate governance reform implemented through shareholder proposals and negative say-on-pay advisory votes. If market discipline is ineffective to cause meaningful change in board and/or management personnel or policies, governance proposals, no matter how enthusiastically embraced by shareholders, would in most cases be similarly ineffective. The only viable solution in cases such as this would be a change in board composition and/or in management accomplished by a conventional proxy contest or change-of-control battle. Put another way, no amount of theoretically good governance policies can make up for lousy management. At the end of the day, economic performance is what counts, not the conceptual elegance of a corporate governance model.

As for index and similar quantitatively managed funds, their “inability” to sell shares to penalize bad performance or bad management is part of their bargain with their investors. Their commitment to their investors is to mirror an index or to observe other quantitatively driven investment guidelines, not to change performance of the index or model through active intervention in company management and governance. By hypothesis, quantitatively managed funds do not purport to have the expertise to monitor and intervene in management decisions, whether operating, strategic, or governance. Attempts by quantitative funds to dictate corporate governance standards for portfolio companies seems a misguided and somewhat quixotic enterprise, wholly outside of the asserted competence and investment thesis of these funds. Indeed, one could argue that the preoccupation with portfolio company corporate governance by personnel of quantitative funds is itself a symptom of a major governance failure within the fund.

Conclusion

Truly good corporate governance is not readily subject to simplistic, one-size-fits-all rules. Corporations are large, often immense, aggregations of people, assets, technology and know-how tied together by very complex systems and cultures. Their purpose is to create economic value for their shareholders, who are not owners of an undivided interest in physical assets or employees or ideas, but rather of a derivative instrument the economic value of which is determined by how much the next buyer is willing to pay for the stock, not by the residual value of the enterprise following liquidation. Truly good corporate governance is about the complex of relationships of the people who lead the enterprise and the systems and policies that influence their behavior. What works for one successful corporation — say, Berkshire Hathaway with its charismatic and brilliant dominant leader — may not work for another — say, Tyco which came to grief under the rule of another charismatic and seemingly brilliant leader.

In short, truly good corporate governance is about human dynamics in a complex organizational setting which is devoted to creation of economic value. There are no simple principles that will always work and always produce value. Good corporate governance more closely resembles art than science. What it does not resemble is a set of rigid rules derived from inept analogies to political models or to different types of legal relationships, such as the laws of tangible and intangible property or agency. The sooner we give up the prevailing mantras of the activist corporate governance community in favor of more sensible and common sense approaches founded on the underlying purpose of the public corporation construct — economic value creation — the better.

Endnotes

1. For an interesting and pithy analysis of the concept of shareholder democracy, see Leo E. Strine, Jr., *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*, 66 BUS. LAW. 1, 3-9 (2010) [hereinafter Strine, *Corporate Governance*].
2. When Berle and Means wrote on this topic in the early 1930s, most stocks were owned by individuals (so-called “retail” investors) and the widely dispersed nature of share ownership was a reality. See ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 333-57 (1932). Today, investing is dominated by institutional investors, which own an ever increasing percentage of publicly traded shares, often estimated to be over 70- 80% of all traded shares. Alan R. Palmiter, *Staying Public: Institutional Investors in U.S. Capital Markets*, 3 BROOK. J. CORP., FIN. & COM. L. 245, 246 (2008) (citing FEDERAL RESERVE BOARD, *FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES* 89, 90, Sept. 18, 2008, available at <http://www.federalreserve.gov/releases/z1/20080918>). Institutional investors have re-aggregated public capital, and it is not uncommon for a large multi-billion dollar market capitalization company to find as much as 60%-80% of its outstanding shares owned by 20 or fewer institutions. A widely dispersed shareholder body today is more the exception than the rule. The re-aggregation of public capital has dramatically shifted the balance of power between management and investors and is the foundation of the corporate governance activist movement of the past 30 years. See, e.g., Strine, *Corporate Governance*, at 11-19; see also Brian G. Cartwright, Gen. Counsel, Sec. Exchange Comm’n, *Speech by SEC Staff: The Future of Securities Regulation*, at the University of Pennsylvania Law School Institute for Law and Economics (Oct. 24, 2007), available at <http://www.sec.gov/news/speech/2007/spch102407bqc.htm>.
3. It is not without its ironies that the institutional investor community suffers as much or more from agency cost issues than the corporate world it seeks to govern. See, e.g., Strine, *Corporate Governance*, at 11-19. Strine also points out that the re-aggregation of investment capital in the form of today’s dominant institutional investors has changed the balance of power so that, in many cases, the more critical corporate governance issue is the separation of the investing and voting functions at institutional investors and the agency costs that separation imposes on corporate value creation. See *id.*
4. This debate has been at the forefront of corporate governance thinking since at least the 1960s, when the first modern wave of “corporate raiders” emerged and pioneered the tender offer. It permeates the legal and academic writings on many governance issues, including the utility and validity of the poison pill, the pros and cons of staggered boards, the confluence of corporate governance activists and activist investors, the desirability and economic utility of proxy contests and much more. For a recent essay on the topic, see Strine, *Corporate Governance*. For a recent case on the topic, see *Air Products & Chemicals Inc. v. Airgas, Inc.*, No. 5249, 2011 Del. Ch. LEXIS 22 (Del. Ch. Feb. 15, 2011).

5. Index investors (and many other quantitative investors) justify their involvement in corporate governance by the analogy of a rising tide raising boats. The core article of faith of corporate governance specialists is that their version of good corporate governance will, on average and in the long run, lead to ever increasing stock prices and thus increased value for their indexed fund products. This argument raises a number of issues. First, index fund managers do not hold themselves out to their investors as having the capability or goal of moving the index which they are supposed to mirror by changing the behavior, and thus the stock valuation, of participating companies. This, simply, is not part of their advertised investment style. Second, there is no empirically based consensus that the core premise of the value-creating efficacy of good corporate governance is, in fact, true. Third, the core premise also relies on the belief that corporate governance can be dealt with abstractly, without regard to the particular circumstances of the 6,500 some odd public companies listed on the major US exchanges, not to mention the approximately 9,000 other U.S. public companies and the thousands more of non-US companies that ISS follows—in effect, that a one-size-fits-all mold is value-creating on a universal basis. Additionally, the rising tide argument ignores the effect on an index of all other micro-economic and macro-economic factors. Why, we might ask, wouldn't an index fund's resources be better spent lobbying Congress and the Federal Reserve Bank to adopt "better" fiscal and monetary policies? It is hard to avoid a conclusion that corporate governance activists at quantitative investors are wedded to the rising boat analogy and its core assumptions because it justifies their role and their job, not because it is part of the fund's investment thesis.
6. Compare Lucian Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675 (2007), with Martin Lipton & William Savitt, *The Many Myths of Lucian Bebchuk*, 93 VA. L. REV. 733 (2007).
7. For example, the Sarbanes-Oxley Act was engendered by a relatively few, but very high profile, frauds at large public companies. The option back-dating "scandal" of the middle of the last decade did not reveal a problem endemic to a vast host of public companies but was largely confined to a relatively modest number of technology and other emerging market companies. The financial crisis of 2008 is popularly attributed to wholesale failures of risk management (and maybe worse) at some of the very largest financial institutions, but it tarred all public companies without regard to their lines of business.
8. See David Walker, *A Review of Corporate Governance in UK Banks and Other Financial Industry Entities* 39-40 (2009), available at http://webarchive.nationalarchives.gov.uk/+http://www.hm-treasury.gov.uk/d/walker_review_consultation_160709.pdf (discussing board size limitations with particular focus on the British system); Robert C. Pozen, Op-Ed., *A New Model for Corporate Boards*, WALL ST. J., Dec. 30, 2010, at A15.
9. Two of the leading shareholder proposals under Rule 14a-8 over the last several years have been to permit shareholders (1) to call special meetings with as low as 5% ownership, and (2) to act by written consent of a majority of outstanding shares at any time. GEORGESON, INC., 2010 ANNUAL CORPORATE GOVERNANCE REVIEW 6-7, 24 (2010) [hereinafter GEORGESON, ANNUAL REVIEW]; ISS, 2010 U.S. POSTSEASON REPORT 15-16 (Nov. 10, 2010) [hereinafter ISS, POSTSEASON REPORT]. The latter proposal is very popular with investors and routinely gains well over a majority of votes cast. ISS, POSTSEASON REPORT, at 16.
10. See, e.g., Strine, *Corporate Governance*, at 23. We believe it would be permissible under most state corporation laws for a company to provide in a board-adopted bylaw that only matters on which shareholders have an explicit statutory, charter or bylaw right to vote can be put on an agenda for a shareholders' meeting. Such a bylaw would restrict shareholders' ability to raise issues to a handful of matters, such as adopting or amending bylaws, removing directors and nominating candidates for director. However, we also think such a bylaw would likely be challenged as preempted by SEC Rule 14a-8.
11. *Sec. Exchange Comm'n v. Med. Comm. for Human Rights*, 404 U.S. 403 (1972); *AFSCME v. Am. Int'l Group, Inc.*, 462 F.3d 121 (2d Cir. 2006); *Sec. Exchange Comm'n v. Transamerica Corp.*, 163 F.2d 511 (3d Cir. 1947).
12. GEORGESON, ANNUAL REVIEW, at 18.
13. ISS, POSTSEASON REPORT, at 23.
14. Proponents of majority voting universally agree that it should not apply to proxy contests (including those that would arise under a proxy access regime) and that plurality voting is the only sensible regime for those contests.
15. The issues and complaints about the hegemony of the two proxy advisory firms in regard to executive compensation is the subject of extensive academic and governance literature. See, e.g., Concept Release on the U.S. Proxy System, Release No. 34-62495, 75 Fed. Reg. 42,982 (July 22, 2010); Comment Letter to the SEC Re: Concept Release on the U.S. Proxy System from the Society of Corporate Secretaries & Governance Professionals to Elizabeth M. Murphy, Sec'y, Sec. Exchange Comm'n (Dec. 27, 2010), available at <http://www.governanceprofessionals.org/Document.asp?DocID=3094>; Letter from the American Bar Association to Elizabeth M. Murphy, Sec'y, Sec. Exchange Comm'n (Dec. 17, 2010), available at <http://apps.americanbar.org/buslaw/committees/CL410000pub/comments/20101217000000.pdf>.
16. This increasingly has become the case since the advent of proxy advisory firms' support of vote-no or withhold vote campaigns based on failure by a board or board committee to implement a Rule 14a-8 proposal that has received a majority vote.
17. See, e.g., Roberta Romano, *Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. ON REG. 174, 187 (2001) (concluding that "[s]hareholder proposals have no significant effect on firm performance").
18. Charles M. Nathan & Parul Mehta, *Corporate Governance Commentary—The Future of Institutional Share Voting: Three Paradigms*, July 15, 2010, available at http://www.lw.com/upload/pubContent/pdf/pub3617_1.pdf; Charles M. Nathan & Parul Mehta, *Corporate Governance Commentary—The Parallel Universes of Institutional Investing and Institutional Voting*, Mar. 26, 2010, available at http://www.lw.com/upload/pubContent/pdf/pub3446_1.pdf.

19. Charles M. Nathan & James Barrall, *Corporate Governance Commentary—Proxy Advisory Business: Apotheosis or Apogee?*, Mar. 3, 2011, available at http://www.lw.com/upload/pubContent/_pdf/pub4042_1.pdf.
20. The corporate governance community has embarked on a campaign to foster “engagement” at each public company, by which it means corporate governance professionals, not investment professionals, meeting with management and directors to discuss corporate governance, not company performance, issues. The most recent iteration of this campaign is the idea that every public company should host a so-called “Fifth Analyst Call” (analogous to the traditional analyst and investor meetings at which company management announces quarterly earnings and explains the company’s quarterly performance). The Fifth Analyst Call would precede the annual meeting, be devoted to governance issues and be attended by company directors who would engage in “unscripted” dialog with investors, presumably represented largely by their in-house corporate governance specialists. For a sense of the real-time dialogue over this proposal, visit http://www.shareholderforum.com/e-mtg/Program/20110322_report.htm and the responsive comments collected there.
21. For a recent academic study concluding that the Wall Street Walk is effective as a governance device for dispersed institutional holdings, see Alex Edmans & Gustavo Manso, *Governance Through Trading and Intervention: A Theory of Multiple Blockholders*, REV. FIN. STUD. (forthcoming), available at <http://ssrn.com/abstract=1102730>.

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