Next steps? Be careful what you wish for

In the name of advancing shareholder rights, let's not harm shareholder interests.

By Peter C. Clapman

In 2004, as head of the corporate governance program at TIAA-CREF, I wrote in its *Policy Statement on Corporate Governance* the following: "Good corporate governance should maintain the appropriate balance between the rights of shareholders — the owners of the corporations — and the needs of the board and management to direct and manage effectively the corporation's affairs." At that time, relationships among shareholders, boards, and management were not balanced, with authority heavily skewed towards management. While some company boards understood their proper role, many did not — resulting in CEO domination.

I am convinced that this same approach to specific issues continues applicable in 2008. However, I now challenge a premise that I previously took for granted: that increasing shareholder powers is always in the long-term interests of shareholders.

A changed scene

Significant strides made in the U.S. to improve corporate governance, including providing shareholders with a considerable array of new rights, have changed the scene, as have the positive changes in boardroom practices under new regulatory and legislative standards. Unfortunately, it took the scandals of 2001-2003, and the market collapse that ensued, to produce these changes. The results, however, were highly productive.

The SEC and Congress, as well as the private sector, examined laws, regulations, and business culture with a goal to restore confidence in the U.S. markets. As time passes, we can appreciate the extraordinary governance changes brought about through Sarbanes-Oxley and other regulatory changes, the stock exchange listing requirements, increased board member understanding of their responsibilities, and more open dialogue between shareholders and managements.

Most importantly, we found a private-sector solution to one of the more significant barriers to better board performance: the broad consensus across constituencies that board members should be elected by majority vote of shareholders. This last change now gives boards a legitimacy that previously was lacking.

Of all of the changes in actual practice, aside from majority vote, the most significant governance advances result from the new stock exchange listing requirements. Foremost among them: boards must meet in executive session without management. As a result, companies have to designate an independent lead (or presiding) director, not only to run the executive sessions but also to have the responsibility of assuring that the board exercises independent board leadership. Another sea change brought about by the new listing requirements is the shift of control from the CEO to the corporate governance committee in the selection of new board members.

In the compensation area, new regulations required shareholder approval of equity compensation plans that could significantly dilute current shareholder interests (early "say on pay"); new regulations also required expensing of stock

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Next steps?

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options. These have undoubtedly influenced how executive compensation is fashioned.

Where to go from here?

We need to look at the corporate governance environment in 2008 and assess what additional changes are appropriate. We need to acknowledge that taking the reforms, singularly and cumulatively, over the past few years, there has been a major shift away from management domination in favor of both the board and shareholders. In short, the balance needed for good corporate governance is much closer to where it should be. I question whether radical shifts in the current balance are desirable.

The key to good governance has always been to promote higher quality performance by the board of directors. Although boardroom practice is far more professional and responsive to shareholder concerns than ever before, board quality is a moving target. We cannot merely affirm the status quo. We should be careful, however, that any further changes do not produce more problems than they purport to solve — that, in the name of advancing shareholder rights, we do not harm shareholder interests.

There are a number of current issues being debated that raise these concerns. First, there is shareholder proxy access, a concept that was proposed by the SEC in 2003. This idea was considered for close to two years before being put aside by the commission, and then given new impetus by a court decision that permitted shareholder resolutions in 2007. None of these resolutions passed, although some received significant minority support. A new rule of the SEC essentially removed the issue for the 2008 proxy season, but it is likely that the issue will reemerge for consideration.

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A power shift has occurred

It is important to remember that the SEC proposal on shareholder access occurred before majority vote was even considered, let alone implemented. Majority vote as a requirement for board elections is now the norm in most of the larger companies in the U.S. As compiled in a study by Claudia Allen of Neal, Gerber and Eisenberg LLP, currently about two-thirds of the companies in the S&P 500 have adopted majority vote and more are expected to do so during the 2008 proxy season. Majority vote could well be the universal standard in the near future as smaller companies are increasingly adopting it. Majority vote for elections means that shareholders, if dissatisfied with board performance, can have a practical means to exercise their opinion. A nonperforming board can be rejected if sufficient shareholder opposition develops. Boards recognize this possibility, and they become more accountable.

We are at a relatively early stage in understanding the full impact majority vote will have on board-shareholder relationships. It would be hard to deny, however, that a significant power shift to shareholders has occurred. The acceptance of majority vote by corporate managements and boards strongly influences my views on shareholder access.

In my view, the debate over proxy access in 2008 should be very different than it was in 2003, prior to widespread adoption of majority vote. Some advocates continue to press for proxy access, potentially at all companies. They argue that proxy access would not be abused or cause dysfunction because a shareholder nominee would need to defeat the board nominee. A problem with that logic is that it ignores the practical effect the contest itself would have on a board. A board contest inevitably distracts a board from its appropriate responsibilities. Furthermore, although few companies may actually confront a proxy contest, every company will have the concern that they will be among those chosen, and perhaps for wrong reasons.

Thus, in contrast to majority vote, which favors consensus, proxy access remains an issue where confrontation and charged rhetoric prevail. Weighing all these arguments, I have written a comment letter to the SEC. It concludes that proxy access should not apply to companies that adopt majority vote, unless such companies ignore vote results that reject its board nominees, and that at least 5 percent of shareholders be required, a figure that should assure a reasonably broad shareholder consensus as to the appropriateness of such a contest. I continue to believe that this approach will strike the proper balance.

Whether shareholders should have an advisory vote on compensation and at which companies — the so-called say on pay — also raises these concerns. One approach, which I favor, would be for shareholders to utilize the shareholder proposal process in selective cases at companies that have demonstrated poor practices. The other approach would be to require such a vote at all companies, as is the practice in the U.K. Congressional legislation to require such votes at all companies has been introduced.

Problems with say on pay

In my view, universally applied say on pay is more problematic than helpful. For all practical purposes, a shareholder right to say on pay already exists, since the option of withholding votes from compensation committee members is not only available but is being widely exercised. Thus, there is a link between this issue and majority vote. Compensation disclosure under recent SEC rules is increasingly complex and lengthy. Considerable work is needed to intelligently assess such disclosure in individual company proxy statements. There is a fair likelihood that companies would begin to standardize pay practices for ease of disclosure, rather than to exercise appropriate judgment as to the particular factors that should best apply to their compensation practices.

If applied to a universe of 10,000-plus public companies in the U.S. (in contrast to far fewer companies in the U.K.), most shareholders simply will not devote the necessary staff resources to vote intelligently as individual shareholders and will outsource the voting decision. The inevitable consequence would be to transfer considerable discretionary power over individual company compensation practices to the proxy advisory firms. I question that such an approach will serve the long-term best interests of shareholders.

The key to good governance has always been to promote higher quality performance by the board.

My conclusions on current-day issues of corporate governance stem from my beginning premise that "good corporate governance" means working to achieve the right balance among management, boards, and shareholders. That balance may mean that adding new shareholder powers does not necessarily equate to advancing shareholder interests. For long-term shareholders, adding new shareholder powers that go too far may actually be contrary to good corporate governance. At some point, by eroding the authority of boards, we risk lessening rather than enhancing boardroom accountability.

Grounded in mutual respect

If adding new shareholder powers may be problematical, what is the best application of shareholder initiatives? Responsible shareholders still need to focus on increasing the quality of board performance. Even with the great strides that have been made, shareholders need to press for wider application of "best practices" in such areas as independent board leadership, board education, board self-assessment, succession planning, and board engagement with long-term shareholders. Within the improvements that have taken place in U.S. corporate governance, there are more than enough shareholders rights to take on these issues. We can start with the responsible use of the proxy vote on director elections and other major issues. For this task to be performed well, more shareholders must devote sufficient resources to make intelligent individualized decisions.

Two other thoughts: U.S. institutions should go beyond just voting — by engaging in more direct dialogue on governance issues with corporate managements and board members, a practice that is now established and working well in England. Further, governance professionals should work with their investment staffs on governance issues to better integrate governance into the investment process.

We must also appreciate that successful implementation of objectives depends on the willing acceptance of such ideas by the corporate community leaders who recognize legitimate shareholder concerns. At some point there will be understandable resistance from the business community if shareholders fail to recognize the positive governance developments they have achieved, and insist on an ever-expanding concept of shareholder rights.

It's a different environment

Additionally, there is a real concern that private equity and hedge fund investors with short-term horizons can use shareholder rights to destabilize companies in furtherance of their goals, to the detriment of long-term shareholders. In such cases, long-term shareholders may need the board to have the ability to resist short-term investor pressures. As private equity and hedge fund investors become more powerful, this is another good reason long-term shareholders should be very careful about tilting the governance balance away too much from directors.

Going forward, we should engage in analysis and debate of complex issues with full appreciation that we are in a very different governance environment than even a few years ago. We collectively can accomplish more to further improve our corporate governance. This can best be accomplished by mutual respect among boards, management, and shareholders. Without such respect, dialogue can easily lapse into confrontation and inflamed rhetoric, all of which would be contrary to the interests of both corporate leadership and shareholders. ■

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