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RESPONSIBLE INVESTING & CORPORATE GOVERNANCE

LESSONS LEARNED FOR SHAREHOLDERS FROM THE CRISES OF THE LAST DECADE

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INTRODUCTION

The repeated corporate crises of the last decade (Tyco, Enron, Worldcom and most recently the various crises that have engulfed the global financial sector) have caused significant economic harm to the public, investors and TIAA-CREF participants. In their aftermath, there has been a vigorous debate among market participants about the root causes of these various crises, the lessons learned and the way forward.

Organizations, both within the United States and abroad, have issued white papers and policy statements that address these failures and offer suggestions for rebuilding confidence and trust in the markets. TIAA-CREF has surveyed the commentary, which provides a range of thoughtful and constructive views on the potential causes of the crises and the suggested steps that should be taken to reform the corporate governance system. This paper will review these solutions and offer our own observations and lessons learned in promoting good corporate governance for more than 90 years.

TIAA-CREF believes the reasons for the various crises of the last decade are multicausal ranging from poor corporate governance and breakdowns in risk management to bad behavior by individual market participants. We believe that all market participants should undertake a comprehensive review of their behaviors, processes and practices to do their part in restoring public trust and confidence in the governance of our public corporations and to maintain it thereafter.

Commentary to date has been immensely helpful in identifying problems and offering solutions, but TIAA-CREF believes that long-term investors who have an effective focus on overseeing their investments will play a vital role in enhancing good corporate governance which in turn will help prevent a recurrence of severe crises in the future. This paper addresses how we believe that focus should work. It also attempts to put into context what we believe are the key lessons learned over the last decade and our view of the role of shareholders going forward to safeguard our economy and markets from future breakdowns in corporate oversight.

THE IMPORTANCE OF CORPORATE GOVERNANCE

Good corporate governance is critical to well-functioning securities markets. We believe that the breakdowns of the last decade have highlighted the need for long-term shareholders to play an even greater role in corporate governance. At the same time, however, we recognize that there are differing roles for individual and institutional investors, and for investors with long- and short-term horizons. TIAA-CREF believes that institutional investors are the constituency whose interests are best aligned with stable and growing markets because of their long-term orientation. The focus of this paper is on institutional investors with a long-term focus (referred to as "Investors" or "Shareholders"). TIAA-CREF has long advocated the merits of involved owners in improving corporate governance. We believe strong corporate governance helps reduce investment risk and ensure that shareholder capital is used effectively.

As providers of capital, long-term investors have among the most to lose if markets deteriorate and asset prices fall. Therefore, it is critical that such investors use their influence and leverage to promote good corporate governance and effectively functioning markets. This makes good economic sense in terms of our mission and is part of our job as fiduciaries representing our clients. Our participants and clients expect us to be stewards of their savings and to help provide for their financial security.

We offer below our observations and lessons learned regarding the role of shareholders in corporate governance. We conclude with a number of recommendations to enhance effective corporate governance. We believe that these steps could promote more effective corporate governance and influence the full recovery of our markets and our economy. While better corporate governance may not have averted the crises of the last decade, we believe that it plays an important role in ensuring efficient allocation of capital as well as providing important monitoring capabilities to potentially avoid future ones.

GENERAL OBSERVATIONS AND LESSONS LEARNED

Monitor Effectively. We believe investors must engage and monitor their investments effectively and constantly. Moreover investors must refrain from a focus on short-term investment performance rather than their more encompassing stewardship and ownership responsibilities. In doing so, investors would be best served not outsourcing this function to third parties who may not have their same time frames or agendas.

Stay Engaged. Investors must engage with companies on governance and long-term performance issues in order to help protect and enhance the value of their holdings. For universal owners, the "Wall Street Walk"[1] or simply selling stock in the face of inadequate performance is not the most attractive option. In active as well as passive segments of portfolios, investors should be vigilant in trying to prevent problems before value is lost and it is too late to sell, or increasingly difficult or expensive to address.

Foster Dialogue. The relationship between shareholders and companies in the United States may in some cases have become unnecessarily adversarial and an opportunity for more collaborative relationships lost. It has been our experience that shareholders sometimes believe boards are not listening and boards believe shareholders are interfering in their business. Neither may be the case, but these sorts of assumptions and misunderstandings can diminish dialogue and collaboration. Shareholders and companies have a common goal of long-term wealth creation, and should work more collaboratively to reach that goal. Legislatively driven solutions are a less attractive means of change. However, they may become an integral component of reform due to the failure of more traditional market-driven responses and the repeated nature of the governance failures.

Encourage Market Solutions. Companies would do well to view good corporate governance as integral to long-term success and achievement of business objectives, not as a "check the box" compliance item. The consistent application of good corporate governance would provide the opportunity to establish more market-based solutions, as opposed to letting problems fester to the point of public outrage and legislative action.

Facilitate Shareholder Participation. When dialogue fails, shareholders need the appropriate tools to bring companies to the negotiation table. While governments and regulators are enacting legislation and revamping financial market regulation, more emphasis should be placed on the role of shareholders in future solutions.

[1] Wall Street walk is the belief that investors need not engage with companies on governance issues but should sell the stock if they do not agree with governance policies. See James P. Hawley and Andrew T. Williams. The Rise of Fiduciary Capitalism: How Institutional Investors Can Make Corporate America More Democratic. Philadelphia: University of Pennsylvania Press, 2000

TIAA-CREF supports proposed reforms designed to give shareholders meaningful rights including (a) access to the proxy to nominate directors, (b) majority voting in director elections and (c) an annual shareholder vote on executive compensation. These rights can increase the accountability of boards if they are designed with the appropriate safeguards and used by shareholders diligently as vehicles to help protect their investments and economic interests.

Maintain Balance. Shareholders should continue monitoring companies, but should respect the role of the board to make business decisions. Importantly, shareholders do not have access to the level, detail and type of information that boards have and are, therefore, at an information disadvantage. The role of shareholders is to hold corporate boards to high standards of accountability, not micromanage a business that boards know well. We believe increased accountability will result in more power, not less for boards, and should strengthen and clarify their resolve to serve long-term shareholder interests.

RECOMMENDATIONS FOR SHAREHOLDERS

Exercise Rights Responsibly. Investors should exercise their rights responsibly to ensure companies are well managed and positioned to drive long-term value. They should vote their shares diligently, recognizing that they are a valuable asset, and a primary means to communicate with the company and other shareholders. Investors should not blindly support management, and should dedicate appropriate resources, including senior management, to proxy decisions.

Hold Boards Accountable. Investors should be willing to take action when they believe the board has not adequately represented their interests. The most fundamental right that shareholders have is the election of directors. Shareholders should be willing and able to remove directors when they have performed badly or have been unresponsive to less aggressive overtures such as high votes against compensation programs or other management initiatives. In order for

boards to achieve long-term value with reasonable risk, their goals should be closely aligned with those of long-term owners. This means shareholders must have the ability to nominate, elect and remove board members and must exercise that right if it becomes necessary.

Monitor Performance. Once they have made an investment decision, investors should be prepared to monitor companies and they should develop skills to do so. Monitoring includes discussions with both the board and management in differing ways, and engagement with companies on issues of concern. Dialogue with directors may include management, but also could in certain cases include unfiltered communication with the board without management. Shareholders should consider many factors in monitoring companies, including long-term performance, board performance, governance and other policies, strategic direction and leadership. Shareholders also should consider factors of risk, both from a perspective of whether appropriate risks are encouraged, but also monitoring performance in the context of the risk taken to achieve desired returns.

Ensure Compensation Is Based on Performance. Shareholders should ensure that compensation policies are performance-based, appropriately tailored to meet the company's circumstances, integrated into and consistent with the business strategy and have a long-term orientation. There are a variety of ways to achieve these objectives. Nevertheless, these strategies should be based on realistic accounting of profits as well as encompass a measurement of risk. In many respects, the most significant flaws in executive compensation reside in the methodologies used for measuring performance, the types of metrics utilized and the failure to recognize that risk-adjusted returns are ultimately the most important. This is an area where close monitoring by investors is crucial.

Compensation decisions provide one of the better windows into the boardroom, and clearly reflect on the quality of the board, its priorities, its ability to balance competing interests and its independence from management. Shareholders have a significant role to play in setting broad compensation policies, and should strive to provide thoughtful feedback to companies through engagement, proxy votes, investor policy statements and advisory votes on compensation.

Defend Integrity of Accounting Standards. Shareholders should take a more active position in defending the integrity of accounting standards. Accounting standards play an important role in our governance system, as the quality of reported information is effectively the life blood of financial markets. The purpose of financial statements should be to transparently represent the true condition of the reporting entity. If a company or industry is volatile or risky, the financial statements should represent this. Investors are otherwise unable to effectively judge risk and allocate capital appropriately.

Increase Communication. Shareholders and boards should work together to develop constructive solutions to the risks posed by governance problems. Communication can be structured or unstructured or formal or informal, but whatever method is used, it should take place as necessary to ensure alignment and understanding of goals.

Encourage More Long-Term Orientation. Investors should encourage incentives which reflect a sufficiently long-term period to incorporate an appropriate capital and investment horizon. Their adoption of long-term perspectives should encourage boards to generate policies for sustainable growth and earnings, and discourage excessive short-term risk taking. Investors should have more discipline in ensuring that they themselves are acting in the long-term interests of their beneficiaries, ranging from dedicating the proper resources to governance and monitoring to ensuring their own reward system is consistent with a long-term strategy.

Strengthen Investors' Own Governance. Large mutual funds and pension funds hold significant stakes in corporate America and, therefore, have the greatest potential ability to influence corporate policies. However, in order to take leadership, they must hold themselves to high standards of governance in their own operations. Fund governance practices should be examined to ensure that any potential conflicts of interests are properly managed and that fiduciary obligations are met.

Examine Investment Practices. Investors should examine their own organization and investment strategies in light of market conditions and determine whether any material alterations are appropriate. The magnitude of the crises of the last 10 years and the impact on portfolios have raised questions regarding the effectiveness of their oversight in our economy. It is clear that shareholders of public companies need to play a more significant role in policy and oversight in the post-crisis environment.

CONCLUSION

Truly engaged shareholders have the opportunity to play a constructive role in rebuilding the markets and maintaining a healthy balance in our corporate governance model. Shareholders must be more watchful and they must be empowered to act on behalf of their beneficiaries. They must also use these rights responsibly to ensure accountability of management. How shareholders respond to this challenge will be critical to the future growth of our economy, the success of our equity markets and increased returns for their underlying beneficiaries.

This paper should be read in the context of TIAA-CREF's Policy Statement on Corporate Governance available on our website **tiaa-cref.org**.