A New Era in Corporate Governance

By Robert F. Felton

More progress has been made improving the governance of US corporations during the past couple of years than in the several decades preceding them. New reporting requirements that stock exchanges have ordered in response to high-profile scandals, together with tougher auditing standards under the landmark Sarbanes-Oxley Act, have pushed boards and managers to become far more diligent in preparing and reporting accurate financial information. Boards have also grown acutely aware of their responsibility to shareholders and of the consequences of failing to live up to it, so many have become more independent from management.

But our latest research on board governance in the United States indicates that directors and investors alike feel that, so far, reform has led to only modest improvement. Much more must change, they think, before high-quality board governance can be achieved.

Although the reforms so far have created more work for finance departments, as well as higher accounting expenses, the direct impact on executives and directors hasn't been particularly troublesome. But the reforms now being demanded by investors and directors we surveyed want companies to move toward separating the roles of CEO and chairman, to make directors more independent and accountable, and to scale back and restructure executive compensation so that it is aligned more closely with the creation of long-term value.

It is perhaps understandable that these deeper reforms haven't yet been pursued. As high-profile corporate abuses have unfolded, one after the other, most boards have become preoccupied with reassessing their responsibilities and implementing the new accounting rules. Although directors themselves shoulder a good deal of blame for the lack of profound reform, they join with investors in pointing to CEO resistance as a primary impediment to it. Certainly, few CEOs see the need for change. The US model of capitalism – with a combined chairman and CEO and a board comprising both insiders and independent directors – has worked well for many companies. So it is simply hardly surprising that CEOs have little desire to share their power or to sacrifice any of their stature or compensation.

A Clear Split

In the summer of 2003 and the winter of 2004, McKinsey surveyed 150 US directors as well as 44 institutional investors with more than $3 trillion in assets under management. Although the surveys were conducted 12 to 18 months after the passage of Sarbanes-Oxley, they revealed an even greater appetite for reform than did a comparable survey conducted in May 2002, just before the laws enactment. For activist advisory groups, perhaps the most important item on the near-term agenda is splitting the roles of chairman and CEO.

Both directors and investors believe strongly that this separation must occur if boards are to provide the kind of independent oversight of management that investors demand. Investors are acutely aware that CEOs have tended to dominate boards over the past decade – sometime with disastrous results – and wonder how a board with the CEO as chairman can oversee management. They also point out that the split structure works quite well in parts of Europe, in Canada and Australia, and in a small number of US companies.

CEOs, thought, are resisting the change. Many aruge that the combined model has served the US economy well and that splitting the roles might set up two power centers, which would impair decision making. CEOs also point out that finding the right chairman is difficult and that there are real negative consequences for choosing the wrong person. Clearly, they will strongly oppose giving the up the power and influence they have worked so hard to accumulate.

Yet given the growing demand for change, CEOs, directors, and investors must form a plan that works for everyone. Since the topic of separating these roles can be highly charged and very personal, the

board should discuss it solely as a business problem. Collectively, the board and the CEO need to come up with an approach that satisfies investors while retaining and motivating the CEO. At a minimum, a lead (or presiding) director should be appointed as a interim step. To bring more credibility to a role that many shareholders view as merely symbolic, however, the lead director must have clearly defined responsibilities and meaningful authority.

At the same time, the board should at least consider the idea of installing an nonexecutive chairman over time. The current CEO might support such a plan upon his or her retirement, which for many companies would be two or three years away. (The average CEO's tenure is now five to six years) Any prospective new CEO would be recruited on the clear understanding that the plan will be implemented. Shareholders are likely to consider these arrangements preferable to losing or diminishing the motivation of a high-performing CEO. In fact, discussions with CEOs indicated that many of them think that the roles of chairman and CEO will eventually be divided; they just hope this doesn't happen on their watch.

Investors shouldn't underestimate the challenge of finding the right non-executive chairman, who must have not only the experience, personality, and leadership skills to mesh with the current board and management but also sufficient independence to show that the board is no longer a rubber stamp for the CEO. If boards wait until regulators or investors force them to start searching for candidates, they may well find that other boards have already snatched up the best ones; in any event, the transition will be delayed.

Soon enough, moreover, investors may well have the tools – proxy-voting provisions and the like – to drive change. It would be better for boards to engage the issue now, and seriously.

Make Directors Independent – and Accountable

Improving a board's performance entails more than separating the roles of CEO and chairman. Significant reforms, ensuring greater independence and accountability, have already occurred in the composition of boards. Recent NYSE and Nasdaq rulings increase the independence of boards and require listed companies to change certain board practices – for example, by improving the audit committee process and retaining auditors and compensation consultants. Meanwhile, the US Securities and Exchange Commission (SEC) is exploring ways to promote "shareholder democracy" by making it easier to elect independent board members directly.

Still to come, however, are changes in board practices and behavior that will be essential if directors are to provide independent oversight of executives. Most of the directors we surveyed said that they still depended on management to set the agenda of board meetings. Few respondents felt that they really knew what was going on in their companies, and most believed that this state of affairs would become increasingly unacceptable. The overwhelming amount of material that directors must master before board meetings, coupled with a lack of time and a culture that precludes openopen and unstructured discussion, has left many board members feeling that they could offer little more than marginal, pro forma counsel. As a result, some directors want real-time performance information unfiltered by management, new meeting formats that foster more open discussion, and the freedom to interact, unfettered by management, with the leaders of business units.

Increasing the accountability of directors is equally important. Althought they report that nearly one-third of their peers are barely adequate or worse board members, rare – rare until recently – was the board that evaluated its own performance, whether of individuals or as a while. In this respect, the change has been dramatic: the percentage of S&P 500 companies conducting board evaluations jumped from 37 percent in 2002 to 87 percent in 2003. These evaluations include everything from the composition of the board to the length and quality of its meetings. Boards taking this approach feel that it gives directors a forum to reflect on their effectiveness as a team and exposes the short- and lon-term issues they face.

Evaluations of individual directors are also becoming more common – but less so than evaluations of boards – and tend to be done with a light touch. To help ensure that individual directors take part in the oversight and governance of the company, and to clarify their roles and responsibilities, many boards are considering more formal evaluations, which examine the contributions of directors to the boardroom: their professional experience, the roles they play, their participation in committees. These more formal evaluations also cover the teamwork of individual directors by asking how well they interact with other board members and with management and how conscientiously they prepare for and contribute to board meetings. While many boards have opted for nonbinding self-evaluations, others have experimented with appraisals that now only incorporate peer and management feedback but also provide an objective base of information for deciding whether consistently underperforming directors should be reelected. These are important steps forward in what is undoubtedly an extremely delicate issue.

Boards can probably best start by using basic evaluation tools that provide developmental and constructive rather than punitive feedback. Intel, for example, is said to require that all directors complete a structured questionnaire and discuss it with the (nonexecutive) chairman to identify how they can improve. This fairly unobtrusive approach has apparently raised the performance of individuals and of the board as a whole significantly.

Whatever evaluation tools may be adopted, directors must understand that over time their workload will increase, especially in view of the added work of complying with Sarbanes-Oxley and with the new NYSE and Nasdaq listing rules. These developments make it essential to have a clearer sense of the effectiveness of the board and its directors and to implement a process for improving both.

Money, Money, Money

Finally, there is the issue of executive compensation, which both the directors and the investors participating in our surveys regarded as an important element in the recent spate of corporate scandals. And with good reason: the transfer of wealth from owners to top management over the past decade has been astounding. In 1992, the top five executives at the 1,700 largest US companies cashed in options worth $2.4 billion; by 2000, that number had soared to $18 billion. In 2000, moreover, the annual income of US CEOs peaked at a multiple of 531 times the average production worker's wage: in short, the combination of cash, bonuses, stock grants, benefits, and options has decoupled compensation from performance.

Investors and directors, upset with the absolute levels of pay and with forms of compensation that have created risk management incentives, want concrete changes. In a few extreme cases, regulators and investors may ask CEOs to return some of the exorbitant sums they have been paid, as Richard Grasso (formerly of the NYSE) recently discovered. Institutional investors such as Vanguard have recently made it a policy to vote their proxies against directors who serve on compensation committees that continue to give CEOs excessive compensation. Influential investment advisers, such as Institutional Shareholder Services (ISS), have started advising clients to vote against members of compensation committees or against compensation plans that exceed certain competitive benchmarks or don't have close enough ties to performance. Of course, a rising stock market in 2003 may have kept some of these tensions at bay. It's one thing for management to claim a large chunk of the profits when the economy booms, buts a returns settle down to historical averages – and some stock market forecasters predict returns below them – investors won't remain idle if an executive team's share of the pie gets larger.

As a result of these pressures, the day is drawing nearer when executive pay will be scaled back. Simpler, more transparent compensation will be more tightly linked not just to the stock price of a company but also to its overall health – as measured, for example, by market share, product quality, and customer satisfaction. Boards will have the unenviable task of balancing management's inflated expectations with what investors think is fair.

In the past, the board's compensation committee would typically benchmark executive pay against a broad industry average and then, as a show of support and goodwill, peg total compensation to the top quartile. With every company trying to pay its executives above-average salaries, the average inevitably spiraled upward. The solution is for a board to index its CEO's compensation to the average of a more narrowly drawn peer group. Higher compensation would then be awarded only for beating it, over two or three years, in total returns to shareholders. Few CEOs will do so consistently.

While CEO compensation will probably never get back to the levels of 1982, when it was a mere 42 times that average worker's pay, it is equally clear that shareholders will resist compensation levels anywhere near those seen in 2000. Boards will have to understand what groups such as ISS and investors such as Vanguard thnk about compensation and then balance their views against the realities of the marketplace for managerial talent. If boards scal back compensation too fast they risk losing their best managers, but it they don't go fast enough they could remain targets for reform. In any case, shareholders expect a significant – not an incremental – recalibration of executive pay.

In addition, the structure of compensation packages must change. Cash should become a much larger portion of the total, and special elements, such as forgivable loans and termination bonuses, ought to be scaled back or eliminated. Many companies have already replaced stock options with cash bonuses or with restricted stock equity, both of which can improve transparency and better align incentives with performance. To prevent the kind of "pump and dump" timing of equity sales that was common n the recent past years, some restrictions now being place on equity awards actually stretch well past an executive's retirement. Restricted equity also gives management more of an incentive to leave companies in the strongest long-term competitive position.

An Uncertain Path

Boards and management teams will find it hard to avoid addressing these three issues: separating the roles of CEO and chairman, increasing the independence and accountability of boards, and controlling executive pay. Investor outrage at corporate scandals drove the passage of Sarbanes-Oxley and the changes at NYSE and Nasdaq. During the most recent annual director election cycle, investors kept up the pressure by submitting an unprecedented number of shareholder proposals. Investors have also forced companies to drop two antitakeover provisions they have long resisted eliminating: poison pills and staggered boards. (In 2003, investors passed 34 fo 46 shareholder proposals to abolish staggered boards, and leading companies, such as Bristol-Myers Squibb, Coca-Cola, and Hasbro, adopted annual director elections.) The investors' success in pushing through these reforms will only fuel enthusiasm for more change.

This new assertiveness will undoubtedly meet with headlong resistance from directors and management teams, especially CEOs. But unless the prevailing mood changes, the investors – with help from regulators and the courts – will likely prevail. Boards should thus prepare for reform. Those that don't will run the risk of being singled out, unfairly or not, by the media or overzealous prosecutors looking to make them the latest examples of corporate malfeasance.

A final reason for action is the upcoming battle for director talent. The combination of Sarbanes-Oxley, which has materially increased the time boards must spend on their fiduciary responsibilities, and investor pressures for board accountability, is changing the value proposition of service as a corporate director. The rewards – prestige and compensation – may remain the same, but the risks have grown. Fewer high-caliber people will therefore be willing to server on boards in the upcoming years. In addition, some companies have adopted limits on the number of boards that their CEOs and other senior executives can serve on. As the talent pool of directors begins to shrink, the best ones will favor companies that have adopted the best governance practices. The remaining companies may have to resort to second-string directors and then confront a vicious cycle of board decline.

The impact of this deterioration may be felt in both the quality of a board's oversight and the capital markets' perception of a company's trustworthiness. As the quality of board members flals off, so too will the quality of the board's oversight and advice. For anyone – like most of the directors in the

survey – who believes that a board's performance can significantly affect a company's, this will be an omen of continuing decline. As corporate performance sags and boards become weaker, they will have an increasingly difficult time attracting suitable new members.

Substantial progress has recently been made in US corporate governance, not least because of the new Sarbanes-Oxley Act. Yet investors and directors are clearly callin for more – and deeper – reforms. Boards that embrace them may will reap a trust premium, while those that continue to ignore the call for change serve neither management no the shareholders well.

Information Technology's Role in Governance

The directors and senior executives with whom we work say that the most critical requirement in corporate governance is raising the quality of the strategy dialogue between the board and management. To do so, both sides must see timely information that shows a company's progress in implementing its strategy – information that isn't necessarily found in quarterly financial filing or in today's board books. What's needed is a set of consistent, unbiased reports, delivered routinely to all board members, that paint a broad picture of the company's situation.

Most companies will need to change their IT systems in four ways to achieve this goal. First, they must ensure the integrity of the data, which should be easily traceable back to original transactions. Managers and board members must be able to drill down through performance metrics to find the root cause of problems – or the genesis of opportunities.

Second, more attention must be paid to the timeliness of information, not only to accommodate shortened reporting deadlines, but also to facilitate faster, more flexible decision making. Once CEO told us, "Getting data that is one or more months old just isn't enough…..I need highly filtered, insightful data at least every other week, preferably weekly." IT systems that are integrated across the company reduce the time needed to reconcile performance data and thus make it possible to deliver information rapidly.

Third, efficient IT systems will tailor reports to the needs and capacity of individual users – from board members looking for insights on strategic risks to managers comparing regional sales data. IT systems should deliver information on business drivers to decision makers according to their individual responsibilities and requirements. One controller told us, "The trick is to move from mountains of data, all synthesized from different sources with different methods, to delivering targeted, consistent, context specific information…This is hard but drives real performance."

Finally, companies should standardize the gathering of data for reports and automate them where possible to create a common, company-wide set of performance metrics – a basic good-governance requirement that a suprising number of companies lack. Standard performance metrics also make it easier to see exception and aberrations. The best systems deliver automated warning alers to senior management when key performance thresholds have been passed (positively or negatively) or use other feedback mechanisms to assure compliance with company policies and standards or with legal and regulatory requirements.

Companies that use their IT systems to improve corporate governance will probably improve their long-term performance as well. Given the effort and expense of meeting the rather narrow concerns or current compliance, the investment is very worthwhile.