

**THE FIFTH ANNUAL INSTITUTE ON
BOARD AND COMMITTEE INDEPENDENCE
AND EFFECTIVENESS**

The Democratization of the Governance Function

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The democratization of the governance function raise numerous questions about the relationships between boards and chief executive officers, organizational control and accountability, and the balance of governance influence in an age of increasing shareholder activism.

These questions touch nearly every facet of board directors' individual and collective responsibility for being stewards of objective, effective and fully updated governance practices. From their implications on executive compensation and director selection to the ways they point to gaps in investor relations and risk management, these contemporary challenges to the traditional balance of power between the board and shareholders portend an even broader shift in governance practices.

It would be unwise to ignore, at the same time, how the current debate about shareholder activism and the increasing democratization and redistribution of influence over corporate leadership is reshaping expectations for the chief executive officer.

GOVERNANCE REFORM, BUT AT WHAT COST?

There is great fluidity and ongoing dialogue about the proper role and responsibility of the board, the CEO and shareholder. It is clear that the traditional balance of control (and transparency) over corporate governance between and among them, including major investor groups, is changing.

The critical question is whether it is changing for the better.

At the center of this ongoing debate is William J. “Bill” Holstein, whose exemplary work to surface, explore and engage boards, CEOs and other parties to governance reform on questions about the emerging democratization of the governance function served not only as a catalyst for our Fall Institute, but also as the focus of this discussion.

Holstein’s significant thought leadership relating to the evolution of board relationships with CEOs and shareholders and his seminal work exploring the influence and potential long-term impact of governance activism has raised serious questions:

Has the current trend of democratization of the governance function had the effect of weakening today’s CEOs?

Are shareholders becoming too powerful?

Can shareholders effectively be involved in choosing new directors and setting executive compensation?

Where should the power lie?

Holstein expertly guided our Institute audience through an insightful exploration of these provocative and timely issues by moderating a panel discussion featuring the perspectives of a distinguished panel of leading governance voices, including **Pearl Meyer**, Senior Managing Partner of executive compensation consulting firm Steven Hall & Partners; **John Wilcox**, SVP and Head of Corporate Governance for TIAA-CREF; **Mike Musuraca**, Assistant Director with the Department of Research and Negotiations for AFSCME; and **Holly Gregory**, Partner in the global law firm of Weil, Gotshal & Manges. We are indebted to Bill Holstein and these panel participants, each of whom helped to make this event a unique learning experience.

BEHIND THE PENDULUM SHIFT

Pearl Meyer, senior managing director of Steven Hall & Partners, says there has been a demonstrable shift in corporate governance practices over the past 15 years that has moved power from the imperial CEO to a more proactive board of directors.

Today's directors, she contends, are "spending an average of about 275 hours a year on board matters, as contrasted to perhaps 150 to 220 hours several years ago." Regulatory agencies and shareholders are also spending increasing amounts of their time assessing the governance function and staking their roles in elevating it.

Boards continue to face mounting pressure from an array of widely diverse special interests, from institutional investors, mutual funds and public pension funds to unions and others with social and environmental agendas. These disparate groups are campaigning to advance their respective agendas, and if they were to succeed, Meyer contends, there could be fractious consequences for the board.

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While the 'Say on Pay' issue continues to garner headlines and votes—despite its rejection of such proposals at numerous shareholder meetings—this proposal as well as other potential reforms and regulatory maneuvers will further transform the boardroom and move the governance pendulum closer to activist interests.

"I think, there are five or seven measures out there right now that will take that pendulum which went from CEO control dominance to board dominance, closer to shareholder interests," Meyer contends.

The challenge for boards moving forward, she adds, is to give disparate activist concerns a hearing and more of a voice in governance interest as opposed to a controlling interest. To achieve that, Meyer argues, "I do think the board has to do a better job in representing and communicating with these various constituencies."

A COMMON OBJECTIVE

John Wilcox, senior vice president and head of corporate governance for TIAA-CREF, says that despite the stark debate about balancing the interests of the board and activist shareholders, he's increasingly confident in the ability of the board of directors to do the right thing.

The right thing, Wilcox says, is for the board "To do the job that we, shareholders, want them to do." Wilcox argues that boards should not be surprised nor confounded by shareholder attempts to strengthen and institutionalize its accountability because the directors are, after all, the elected representatives of the shareholders.

At their core, Wilcox points out, the evolving change efforts of shareholders operating in the best interest of the corporation seek "to strengthen the role of the board, not to take power away from the board..."

Further, Wilcox explains, "Shareholders have a common objective with the corporation, which is to maximize value. And when we zero in on the corporation, it is because the corporation and its board of directors are not achieving that objective, which is a shared objective."

In taking issue with various proposals from the Securities and Exchange Commission, Wilcox asserts, organizations such as TIAA-CREF can also find common ground with the agency's principal objectives while concurrently working as a partner in sensible regulatory reform to ensure real board accountability.

Reflecting on what has been cast as a power struggle over control of the board and corporate assets, Wilcox offers the following advice and admonishment in

the interest of better overall communications and governance practice.

“Directors [should] not to be afraid of shareholders,” Wilcox says. “I would urge boards of directors to think of shareholders in the same way that you think of your customers. And I have to say to many boards of directors that if you treated your customers the way you treat your shareholders, you would be bankrupt.”

Those sentiments were echoed by Mike Musuraca, assistant director in the Department of Research and Negotiations with AFSCME, who offered strikingly similar advice to the board when it comes to dealing with their constituent shareholders.

You should treat us more like customers than enemies because we have an interest in success,” Musuraca says. “That’s what pays the benefits that our members are banking on to have some sort of retirement.”

Further, he adds, what institutional and interest group shareholders are asking for is the right to participate in the direction of the board, its governance practices and the setting of accountability standards for its organizational stewardship role so that directors can be more accountable to all stakeholders.

AVOIDING AN OVERREACH

Holly Gregory, a partner in the law firm of Weil, Gotshal & Manges LLP who specializes in counseling on corporate governance matters, believes it is in the best interests of activist shareholders and the board to find consensus in a cooperative model. She acknowledges a “50- to 70-year history of managerial dominance in a system that was supposed to have managers accountable to boards and boards accountable to shareholders, and, frankly, that was largely a fiction.”

But Gregory also cautions that the pace of reform in corporate governance—which many, like Bill Holstein contend has risen to the point of a democratization of the governance function—has been so accelerated as to create concern about their practical implementation and longer-term impact.

“We’ve had a whole series of reforms very recently... Boards have been hit with new laws, regulations, and listing rules every year for the past couple of years,” she says. “Some of the tensions that we see between boards and CEOs is very likely a function of getting used to the new rules and needing to have time to assimilate.”

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Gregory says that governance reforms haven’t yet had a chance to settle out and normalize, and the extended proliferation of governance proposals could potentially create an overreach that gives shareholders too much external leverage over the board’s fiduciary responsibilities.

People on all sides of the governance debate must understand, Gregory adds, that “Boards are a very special kind of organ. They’re a consensus organ. They’re not meant to be a legislative organ. They work by common agreement, and well-functioning boards are boards in which after disparate views are fully explored and debated a common agreement can be found...”

Moving forward, she says, “Boards need to be carefully crafted to make sure that you have the right mix of people with the right mix of experiences...And I think that the time is right to begin a healthy discussion about the limits of shareholder power.”

Gregory adds: “Shareholders have been highly successful in helping to put a whole host of governance reforms in place, and Corporate America has been very, very responsive, with the move to majority voting just one example.” But, she continues, “There are natural limits to the shareholder role. For example, the board has to be able to set executive compensation. So I have some concerns about the say on pay movement and whether we’re beginning to

see shareholders trying to edge into some areas that really would be overreaching.”

At the end of the day, Gregory reminds us, “Shareholders traded responsibility for control of the corporation for limited liability. The board has the responsibility for directing and managing the affairs of the corporation—and liability.”

CLOSING THOUGHTS FROM BOARDROOM CONSULTANTS

The practice experience of our Boardroom Consultants advisors and the perspectives of the thought leaders who engaged in this important discussion about the democratization of the governance function invariably lead us to highlight the implications of this important issue:

- It’s clear that boards are facing mounting pressure from myriad special interest groups. Directors must balance better representation of and communication with these emerging voices on corporate governance with their responsibility to act in the fiduciary best interest of all shareholders.
- Boards should think of their shareholders in the same manner they think of their customers. Directors and shareholders share a common objective—maximizing value. Shareholders want directors to be accountable for unsatisfactory performance and excessive executive compensation that seemingly gets in the way of achieving that mutual objective.
- Whenever there is a disconnect—real or perceived—between the actions of boards and the interests of shareholders, governance reforms offer both creative solutions and the potential for an imbalance in the board-shareholder compact.
- Governance best practices usually emerge once new reforms are given time to normalize and directors and shareholders alike can see the practical impact of new board leadership standards.
- We also can’t lose sight of the board’s critical role in the management succession process—especially leading up to a CEO transition—and its unique nominating and governance responsibilities to ensure that senior-management and its own directors are individuals who can be effective stewards of shareholder trust, fiduciary responsibility and true organizational accountability.

ABOUT THE SPEAKERS

John F. Akers, Former Chairman & CEO – IBM Corp Director – W.R. Grace, Lehman Brothers

John H. Biggs, Former Chairman & CEO – TIAA-CREF Director – Boeing

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