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Ira M. Millstein[1]
Sr. Partner, Weil, Gotshal & Manges, Sr. Associate Dean for Corporate Governance, Yale School of Management

"Future Steps"

Introduction

Corporations everywhere have the same basic legal features. And, corporations with dispersed ownership are owned by investors, managed by managers and directed by boards. But that's where the similarities end.

Each governance system has a distinct "balance of power" and set of tradeoffs among shareholders, boards and managers.[2] In some jurisdictions, the power tilts to the managers, but in other jurisdictions, it tilts to the shareholders. It may not be a dramatic imbalance, but

[1] The author acknowledges the invaluable assistance of Weil, Gotshal associate Rebecca Grapsas.

[2] REINIER R. KRAAKMAN ET.AL, THE ANATOMY OF CORPORATE LAW (2004) 67.

even a tipping of the scales makes a difference. Where the balance of power lies impacts how specific laws and regulations deal with the agency problems arising from the corporate form. No work has demonstrated this better than the new treatise, *The Anatomy of Corporate Law* ("*The Anatomy*"), published in 2004 and authored by 7 outstanding, internationally well-known and respected academics.

The Anatomy demonstrates that in the U.S. the dominant agency problem is the manager-shareholder conflict and "the most powerful corporate constituency is professional management."[3] It goes on to demonstrate that this balance of power in favor of management plays out in a variety of laws and regulations that are "relatively *unfriendly* to the interests of the shareholder class by international standards." This dynamic is reflected in matters such as shaping corporate policy and decision-making through the shareholder meeting, defending against takeovers, consultation and proxy solicitations, executive compensation, shareholder voting on selection and removal of directors, and the like.[4]

The tilt to managers rather than shareholders was not an accident, the authors of *The Anatomy* suspect; but rather, in the U.S., is because of "the considerable political power of corporate managers."[5] Not only does this seem obvious and intuitive, but another new book – *Political Power & Corporate Control* by Peter A. Gourevitch and James Shinn - likewise concludes that the balance of power is the result of political power and custom; it varies around the world, with the tilt toward different places depending on who has political power, and the demands of society.

The authors of *The Anatomy* also correctly conclude that in the U.S., managerial dominance of the system probably started and continued because things were going well for the economy and corporate

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[3] *Id.*

[4] *Ibid* at 47, 67-70.

[5] *Ibid* at 49.

America.[6] They note that shareholders have little incentive to exercise their latent legal powers during periods of prosperity and rapidly rising share prices because it would appear their interests are being looked after. In periods of stress, however, managerial dominance becomes tested and reduced somewhat. We have had such periods in the past, and we are currently coming through a period of the serious crisis in confidence which resulted in Sarbanes-Oxley and a host of new regulations, listing requirements, criminal trials and sentences, best practices, box-ticking intermediaries and other tests of managerial dominance. This, together with the rising concentration of ownership in institutional investors leads me, and others, to wonder whether we will witness a true shift in power away from the managers over to institutional investors as a class? Or will the institutions behave as shareholders of the earlier dispersed class tended to do, that is, fall asleep?

This is the future I want to peer into.

Let's look at the two core elements of corporate governance to see what a difference in the locus of power might mean, and whether shifting is worth the candle.

Two core elements are needed to ensure that power resides in those who own the company – the shareholders:

- First, and most importantly, shareholders would have the power to select and remove directors. Without this power, shareholders are stripped of their right to chose who should run the company on their behalf. They can only at best, today, ratify the Board's choices.
- Second, the board would have the power to hire and remove management. Without this power, the board cannot ensure that those to whom it has delegated responsibility for running the day-to-day affairs of the company are, in fact, running it in the best interests of the shareholders.

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[6] *Ibid* at 70.

The Core Elements in the U.S.

Up until a few years ago, neither of the core elements was present. Boards did not seem to be aware they had the responsibility to know enough about the company through greater involvement, to replace non-performing managers before a disaster struck. And shareholder rights with respect to director selection and removal were either extremely costly to exercise (for example, proxy solicitation) or virtually non-existent (for example, removing directors and, up until recently, the ability to communicate with other shareholders).

The past few years have seen the balance of power shift from management alone, to management and the board. Boards began awakening in the 1980s, in the face of takeover threats and lawsuits, and have come into their own since the Sarbanes-Oxley reforms and the like crystallized how corporate governance was always intended to work.

This change occurred both voluntarily and by law and regulation. As a result, the responsibility of the board to remove management in a timely fashion is now widely recognized and accepted. In this way, the second core element – the power, indeed responsibility, of the board to hire and timely replace management – now seems to have become embedded in the U.S. system of corporate governance. We should hope that it remains so.

However, the first and most important core element – the power of shareholders to select and remove directors – is not embedded in the U.S. system. Its absence has become glaring. Recent reforms such as mandated independent nominating committees for listed companies, voluntary adoption by boards of governance guidelines with respect to majority voting, and the forthcoming SEC proposal to change the proxy solicitation rules to allow use of the internet and thereby reduce costs, do not go far enough. More would be needed.

U.S. corporate governance, if it is to result in a meaningful shift in power, will need to evolve to give shareholders greater rights of selection and removal. The conditions for this evolution are now ripe - ownership is increasingly concentrated in the hands of institutional investors and away from dispersed shareholders. It is possible that power with respect to board composition could shift to institutional investors and away from management and the board (although power to run the company day-to-day will, and must, remain with management.)

The business community has so far been successful in resisting this power shift. Managers and boards will not easily relinquish their ability to control the board's membership and we cannot deny the existence of their political voice. For example, the response of the business community was an important factor in the SEC shelving its proposed shareholder access rule.

The business community may point to the UK experience – where the right to remove is rarely exercised in practice – to further an argument as to why those rights should not be granted in the U.S.. This would be a simplistic argument, as the existence of these rights gives shareholders the ability to conduct a constructive dialogue with the board, enabling them to achieve their objectives without requiring actual exercise of the rights. It may be that possessing the right negates the need to actually exercise it very often.

However, real rights of selection and removal should not be granted – and the community beyond managers and boards will have just cause to resist their being granted – unless institutional investors demonstrate that they can, and will, exercise such rights in a responsible fashion.

This will require institutional investors to commit to exercising judgment - not following the decisions of others by rote - with respect to their voting and access decisions.

Shareholding Institutions – Not Intermediaries – Should Exercise that Judgment.

Decisions with respect to voting and access should be made by institutional investors themselves and not by intermediaries. Intermediaries can provide information about a company, but not a judgment applicable to all shareholding institutions and their varied beneficiaries. Deciding who should be on a board of a particular company and who shouldn't, requires institutional investors to use their own judgment in analyzing the particular circumstances of that company, and the needs and expectations of their varied beneficiaries.

In making these decisions, shareholders need to think about what the profile of the board under analysis should be. They should ask: in which areas is this board lacking and how can it improve? For example, does it need another financial expert? Does it need someone with in-depth industry knowledge? Does it need someone who can provide a fresh approach to strategic decisions? Does it need someone with a more diverse background who can provide an additional perspective to matters under discussion? Are there any directors who are not contributing and should therefore be removed from the board in any event?

Moreover, institutional investors should reveal their decision-making processes with respect to board selection and removal decisions in the same way as the independent nominating committee is required to under listing standards. This transparency will assist institutions to assure the marketplace of the quality of their decisions.

Institutional investors should thus make board selection and removal decisions based on their own standards. They should not rely on uniform standards prepared by an intermediary.

Such decisions will lack judgment as standards set by intermediaries are intended to be applied uniformly without regard to the individual needs or circumstances of a company, or the varied beneficiary base of the institutions.

For example, advice prepared by an intermediary may stipulate that shareholders should only propose directors who are "independent," according to that intermediary's standards (for example, disqualification because he or she is a former CEO of the company). However, a shareholder exercising judgment may decide to propose a director who has essential industry expertise, even though not fitting an intermediary's strict definition of independence.

Institutions, to be "real" shareholders, truly acting for their respective beneficiaries, must begin to think for themselves. They may very well have varied judgments amongst themselves, but that's how the marketplace is supposed to work.

Conclusion

The shift in power to institutional investors should not occur until such a shift is credible in the eyes of the marketplace – for with power comes responsibility. What will it take to make the shift credible? How can we be assured that institutions will use individual judgments (which is how a marketplace, even of ideas, is supposed to work), as opposed to becoming a "herd"? Is it likely that a shift will lead to "better" performing boards than our current system provides? Such questions require in-depth study. We will make this a priority in our work at the Yale School of Management's new Center for the Corporation, Governance and Performance.

Until research sheds more light on these issues, there are important steps that institutional investors can take to enhance the credibility of their decision-making processes. The mechanics of their decision-making processes should be transparent, and judgment and decision-making should not be outsourced.