Restoring Trust in Corporate Governance: The Six Essential Tasks of Boards of Directors and Business Leaders

Policy Brief

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Policy and Impact Committee of the Committee for Economic Development
Restoring Trust in Corporate Governance: The Six Essential Tasks of Boards of Directors and Business Leaders

POLICY BRIEF
## Contents

**EXECUTIVE SUMMARY** ................................................................. xi

I. INTRODUCTION .............................................................................. 1

II. RESTORING TRUST WITH SIX ESSENTIAL GOVERNANCE TASKS .......... 3
    1) Redefining the Mission of the Corporation—and the Roles of the Board of Directors and the CEO .... 3
    2) Revamping the Leadership Development Process .......................................................... 4
    3) Refocusing the Process for CEO Selection—and for Other Promotions into High Corporate Positions .......................................................... 4
    4) Reformulating Operational Objectives for Performance, Risk and Integrity .............................. 5
    5) Revising Compensation for the CEO, Senior Executives and Other Key Employees .................. 9
    6) Re-aligning the Board’s Oversight Function ........................................................................ 10

III. OBSTACLES .................................................................................. 13
    1) Labor Markets ......................................................................................... 13
    2) Differing International Standards ..................................................................................... 13
    3) Changing Board Compensation Advisors ........................................................................... 14
    4) Short-Termism of Institutional Investors ............................................................................ 14
    5) Manipulating the Numbers .............................................................................................. 15
    6) The Reduction of Pressure for Change .............................................................................. 15

IV. ACCOUNTABILITY AND LEADERSHIP ........................................... 17
    1) The Market .......................................................................................................... 17
    2) Shareholder Involvement ............................................................................................. 17
    3) Government Regulation ................................................................................................. 17
    4) Back to the Future: The Duties of Boards of Directors and Top Business Leadership ............ 18

ENDNOTES .......................................................................................... 19
## Board of Directors

<table>
<thead>
<tr>
<th>Name</th>
<th>Position</th>
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<tbody>
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Restoring Trust in Corporate Governance: The Six Essential Tasks of Boards of Directors and Business Leaders

PREFACE

In a series of Policy Statements since 2006 on corporate governance issues, the Committee for Economic Development has analyzed: first, how corporations could regain the public’s trust in the wake of the Enron-WorldCom scandals; second, how corporate directors could promote the long-term enduring qualities of their enterprises rather than give in to financial market “short-termism;” and, third, how corporate leadership could be rebuilt by linking long-term performance with societal goals.

Since these reports, the nation (and the world) has been hit by the worst economic crisis since the Great Depression. One cause was poor business decision-making by boards of directors and senior executives in both the financial and industrial sectors. Corporate compensation, in particular, has been sharply criticized as poorly structured, a cause of excessive risk-taking and out of proportion to good judgment and common sense. These developments, combined with a constant media barrage of stories about business issues, have combined to drive public confidence in business to a very low ebb. Cries for more regulation of business are coming from many quarters.

In a period of economic turmoil and public policy ferment, this Policy Brief seeks to identify the six essential and seamless tasks which boards of directors and senior executives together must discharge to create long-term value through strong economic performance, sound risk management and high integrity. To help restore deserved trust in corporate governance and accountability, it seeks to provide an actionable framework on the fundamentals for private-sector leadership. Corporate leaders must balance risk-taking (innovation and creativity) with risk-management (financial and operational discipline) and fuse high performance with high integrity to create durable, sustainable growing economic enterprises that benefit shareholders and other critical stakeholders.

This Policy Brief is released when necessary, spirited and extensive regulatory debates are taking place on the safety and soundness of the financial system and on governance issues applicable to all publicly held companies (e.g., disclosure on compensation and risk; enhanced shareholder role). But, the Policy Brief purposely focuses exclusively on private sector self-determination, not public sector regulation. The reason for this approach is straightforward: a deep-seated belief that, whatever the outcome of the many public inquiries and varied public policy debates, only the leadership of corporations—boards of directors and senior executives—can make the complex decisions that will yield sustainable, durable creation of value with sound risk management and high integrity. Because this role of corporate decision-making is enduring and critical to our nation’s economic well-being, the Policy Brief encourages corporations to focus on these essentials, which are fundamental regardless of policy outcomes, as we move across the business landscape altered by the Great Recession.

This Policy Brief seeks to build on, add to and tightly focus the work of CED and other leading governance groups on today’s problems. It also integrates insights from Ben W. Heineman, Jr.’s ongoing research and writing on corporate integrity. It is intended to be an actionable, practical ideal. It is intended to stimulate discussion on the essentials of corporate governance. It is, of course, hardly the final word on this topic. But, for those who must focus on making real-world decisions about the destiny of publicly held companies, it is an invitation to focused debate on corporate leaders’ most fundamental tasks.

This Policy Brief is authored by Ben W. Heineman, Jr., former GE Senior Vice President for Law and Public Affairs. He is a CED Trustee and chair of the CED Subcommittee on Corporate Governance, senior fellow at Harvard University’s Law School and Kennedy School and member of the advisory board of the Millstein Center for Corporate Governance and...
Performance at the Yale School of Management. He is the author of *High Performance with High Integrity* (Harvard Business Press, 2008). The Policy Brief was written with the active engagement and advice of CED’s corporate governance subcommittee.

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The business community faces a crisis in confidence. Many are asking: how can corporations govern themselves more effectively?

—This Policy Brief describes six fundamental, interrelated tasks which boards of directors and senior executives should discharge in governing publicly held corporations in order to regain the vital trust upon which business is based. It hopes to make a singular contribution by defining the six essential governance tasks, by emphasizing their interrelationship and by showing that these seamless tasks are the touchstone of corporate accountability.

Boards of directors in particular should focus on these six tasks in clarifying a “right-sized” role going forward. This will require focused intensity. But, the CEO and other senior company executives must make these tasks the core of their leadership and management efforts as they “govern” the company on a day-to-day basis. This Policy Brief is not just about the role of boards of directors but also about the importance of a powerful board/business-leader partnership in directing the destiny of publicly held corporations.

By showing how closely, indeed seamlessly, these six tasks relate to each other, this Policy Brief hopes to provide an affirmative, actionable framework which boards and business leaders can apply, as appropriate, in their own corporations (to the extent they are not doing so already, which some certainly are). Although written in a prescriptive form, this paper, prepared in the aftermath of the greatest economic down-turn in 60 years, is intended to stimulate an important discussion on the essentials of corporate governance, not to exhaust or end it. It encourages debate on the substance of what corporations should do, not just on the processes for how to do it.

The six seamless tasks are:

1) A redefinition of the mission of the company—and the role of the board of directors and the CEO to create durable value for shareholders and other stakeholders through sustained economic performance, sound risk management and high integrity. This requires that leaders must find a sound balance between risk-taking (innovation and creativity) and risk-management (financial and operational discipline) and must fuse this high performance with high integrity (commitment to law, ethics and values to reduce legal, ethical, reputational, public policy and country risk). The emphasis on short-term maximization of shareholder value should be reduced significantly.

2) A revamped internal leadership training process built on these integrated essentials of performance, risk and integrity—and on a culture in which all are honored and exemplified.

3) A refocused CEO selection process, flowing from a revised leadership development process, which seeks a broader set of skills appropriate to a redefined mission.

4) A restatement of fundamental but operational financial and non-financial measurements for performance, risk and integrity that expresses the near, medium and long-term corporate goals—with primary focus on creation of sustainable value for shareholders and other stakeholders, such as employees and customers, essential to the company’s well-being.

5) A revision of compensation for the CEO and top business leaders—and for other employees with significant impact on the corporation—which is based on real performance against those restated operational objectives in the performance, risk and integrity dimensions. Although top business leadership will receive substantial annual cash compensation, a significant proportion of compensation in a particular year will be variable cash and variable equity which will be paid out or held back over time as objectives are met, exceeded or missed.

6) A re-alignment of the board’s fundamental oversight function with the highest priority performance, risk
and integrity issues—those operational objectives which are central to attainment of corporate mission and to compensation based on the impact of actions over both nearer and longer terms.

Corporations’ current statements of purpose may make reference to these six fundamental tasks. But, the tasks may either be lost amidst many other corporate goals or may not be matched by robust practice. The harsh reality is that business organizations must be designed—by boards at a conceptual level and business leaders at both a conceptual and operational level—to check short-termism, greed and corruption and to channel capitalism’s innovation and “animal spirits” into sustained, durable creation of real economic value within a framework of financial discipline, law, ethics and values.

A relentless focus on the six fundamental tasks is an important guide to creation of sustainable shareholder and stakeholder value. Moreover, developing appropriate executive compensation—the governance topic generating the most public heat today—can only flow from definition of corporate mission and articulation of related operational goals and measurements.

—This Policy Brief also identifies difficult, real-world problems which boards of directors and business leaders must candidly confront because these issues can undermine a corporation’s will and ability to discharge the six, seamless tasks in a meaningful way. These problems include: competition in the labor market for top executive and other business talent; differing regulatory standards and the risk of regulatory arbitrage; the limitations of many current compensation consultants; the increasing short-termism of many institutional investors; and the dangers of gaming any system of measurements. Each company will need to devise its own response to these issues. This report briefly notes some possible solutions to these problems in the interest of stimulating debate and highlighting governance agenda items for further research and analysis.

—Finally, the Policy Brief discusses the ultimate governance question: how can corporate accountability be assured? The pricing signals from the stock market, an enhanced shareholder role in governance and increased government regulation all may have a role. But all have important imperfections in assuring accountability. All are the subject of strenuous debate.

The most direct accountability mechanism is sound stewardship by the CEO and senior executives under the direction and oversight of hard-working, independent-minded boards of directors who are best positioned to balance the many competing interests at play in all significant corporate decisions. Critics argue that this accountability mechanism is weak because boards can be self-perpetuating and inward looking, incapable of asking CEOs hard questions and ignoring important shareholder or other stakeholder concerns.

But the other methods of accountability are, in many respects, all aimed at the fundamental goal of this Policy Brief: strong, energized boards and business leadership dedicated to the discharge, in good faith, of the six essential functions, in part through meaningful consultation with shareholders and other important stakeholders.

* * * * *

Many reports, like this one, address hard problems, with deep structural roots, by calling for leadership. Too often that plea goes unanswered—or the structural problems are too intractable. But today, with a governance crisis in confidence, it is in the interest of corporations and of capitalism itself for people in leadership positions truly to address the governance problems of the era and provide a clear, credible and powerful private sector response.
I. Introduction

The business community faces a crisis in confidence. Many are asking: how can corporations govern themselves more effectively?

This Policy Brief describes six fundamental, interrelated tasks which boards of directors and business leaders should discharge in governing publicly held corporations in order to regain the vital trust upon which business is based.

As discussed in more detail below, the first task is to redefine the corporate mission away from short-term maximization of shareholder value towards three reinforcing objectives: creation of durable value for shareholders and stakeholders through—

a. sustained economic performance
b. sound risk management and
c. high integrity.

From this general restatement of mission flow the five other tasks:

2. revamped leadership development;
3. refocused CEO selection;
4. reformulation of operational goals to reflect the broader mission;
5. revision of compensation to reward attainment of those operational goals; and
6. re-alignment of board oversight to track the highest priority performance, risk and integrity issues.

Boards of directors in particular should focus on these six tasks in clarifying a “right-sized” role going forward. This will require energy and intensity within the normal time parameters of board service. But, this laser-like board focus will only be possible if the CEO and other senior company executives also make these tasks the core of their leadership and management efforts as they “govern” the company on a day-to-day basis. This Policy Brief is not just about the role of boards of directors but also about the importance of a powerful board/business-leader partnership in directing the destiny of publicly held corporations.

By showing how closely, indeed seamlessly, these six tasks relate to each other, this Policy Brief hopes to provide an affirmative, actionable framework which boards and business leaders can apply, as appropriate, in their own corporations. Such a framework is of special importance in orienting the company towards the essential in an era when any commonality among shareholders has broken down—indeed shareholders have many conflicting objectives and agendas—and when stakeholders, too, make many competing demands on the corporation. The forward trajectory of corporations involves a balance between many competing objectives and claims—not pursuit of one simple goal—and, at the end of the day, only boards and senior executives can make the complex decisions to find the right balance.

Although written in a prescriptive form, this paper, prepared in the aftermath of the greatest economic down-turn in 60 years, seeks to stimulate an important discussion on the essentials of corporate governance, not to exhaust or end it, by arguing for the primacy of the six fundamental tasks. It encourages debate on the substance of what a corporation should do, not just on the processes for how to do it. It discusses illustrative concepts to provide context but hopes to avoid mind-numbing or rote box-checking detail.

This crisis of confidence in corporate governance has many origins. Major financial institutions (banks and investment banks) and industrial companies (automobiles) have gone bankrupt with significant injury to all stakeholders. Important financial service companies contributed to the credit melt-down and severe recession (through, among other things, poor risk management, high leverage, inadequate liquidity, creation of ill-understood products). High, poorly structured corporate compensation has drawn sharp criticism as a cause in excessive risk taking and as
out of proportion to good judgment and common sense. And other corporations in both the financial and industrial sectors, even those which are well-run, are not immune from general reputational harm to business caused by almost two years of headlines about corporate problems, excesses and failures.

To address these real and perceived issues about corporate leadership, about corporations’ ability to govern themselves effectively and about corporate accountability, there are two broad options:

• more public-sector regulation to limit private-sector self-determination either in the financial sector or across all publicly held corporations; and

• more broad-gauged, transparent and effective private-sector leadership to articulate the core purposes of public corporations and to carry them out with rigor.

This Policy Brief focuses on the second option: enhanced corporate self-governance at all publicly held companies.¹ It builds on prior policy statements from leading governance groups² and on recent reports about the causes and cures of the financial and automobile company melt-downs.³

It hopes to make a singular contribution by defining the six essential governance tasks, by emphasizing their interrelationship, and by showing that these seamless tasks are the touchstone of corporate accountability.

A company culture that truly makes the six interconnected tasks a reality is necessary whether or not there is additional public-sector regulation. Some companies discharge some of these tasks; some may discharge all. But, to meet the demands of the times, all companies may find it helpful to re-assess their current approach against these six priority actions. At the end of the day, whatever the result of the public-policy debates about governance structure and process, only outstanding boards of directors and outstanding business leadership can together make corporations work.
II. RESTORING TRUST WITH SIX ESSENTIAL GOVERNANCE TASKS

In this period of economic upheaval and change, boards of directors and CEOs are buffeted from many sides with conflicting demands about what they should do. A common board lament is being overwhelmed with too little time and too much complexity.

In arguing that boards of directors and business leadership must discharge six core tasks in order to regain public trust, this Policy Brief underscores that these are seamless, building upon and reinforcing each other. While the details of discharging these tasks will necessarily vary with company, industry, geography and competition, focusing on them together as actionable, core functions will help answer the pressing question asked by boards and business leaders: what should be our priority tasks?

Attempting to draw the line between board-of-director and business-leader responsibility is not the purpose of this Policy Brief. The long-standing proposition that the board of directors sets the corporation’s direction and oversees implementation—and the CEO and senior executives lead and manage the corporation itself—continues to apply. Too much of the governance writing, especially since Enron, has emphasized the board’s role in being a check and balance on management, as if they are necessarily in perpetual opposition.

But—and this must be emphasized—if the board correctly defines the jobs of the CEO and top business leaders and chooses the right people, the primary relationship should be a questioning but affirmative partnership. That partnership critically but constructively tests the reasonableness of both the fundamental systems and processes instituted by management and the high priority decisions and results flowing from those systems and processes.

1) Redefining the Mission of the Corporation—and the Roles of the Board of Directors and the CEO.

Far too much emphasis has been placed in recent years on the single corporate goal of maximizing short-term earnings per share, stock price and shareholder value. As discussed below, this is due, in important part, to pressures exerted by the change in institutional investors who are increasingly preoccupied with short-term results, with beating composite industry benchmarks and with their own absolute profitability, rather than company fundamentals.

A statement of the mission of publicly held companies, appropriate to these times, is creation of durable shareholder and stakeholder value by:

- **Attaining high performance** which means: strong, sustained economic growth; through the continuous provision of high quality goods and services; which in turn provide durable benefits for shareholders and other stakeholders (creditors, employees, customers, suppliers, communities, regulators) upon whom the company’s health depends.

- High performance entails an essential balance between risk-taking (the creativity and innovation so essential to the growth of our economy) and economic risk-management (the financial, commercial and operational disciplines so essential to the soundness and durability of business institutions).

- **Creating a culture of high integrity** which means: robust adherence to the spirit and letter of the formal rules, legal and financial; adoption of global ethical standards which are in the company’s enlightened self-interest and which bind it and its employees as if they were formal rules; and securing employee commitment to the core values of honesty, candor, fairness, reliability and trust-worthiness in all internal and external relationships.

- High integrity has positive benefits inside the company, in the marketplace and in a global society but it also addresses serious legal,
regulatory, reputational, communications and public-policy risks which are also important facets of contemporary business.

- **Fusing high performance with high integrity.** This fusion of sustained economic performance with a strong commitment to law, ethics and values is the foundation of the contemporary corporation.

- **Properly addressing business-in-society issues.** In balancing risk-taking with risk management and in fusing high performance with high integrity, contemporary CEOs, and their top business associates, need to pay systematic attention to business-in-society issues: how society can and will affect the conduct of business; how business has an impact on society; and how business leaders should shape and communicate the alignment of business with societal interests through the concept of corporate citizenship.

As emphasized, each company will give detailed meaning to these concepts of performance, risk and integrity, but together they constitute the core mission of the contemporary corporation and define the fundamental role of the board of directors, the CEO and other senior executives.

2) **Revamping the Leadership Development Process.**

Corporations often provide highly specialized training in such business skills as sales, marketing, finance, IT, business development, manufacturing, engineering and product or technology development. They also may provide less specialized, more general training for P&L (profit-and-loss) managers, who are promoted from positions of narrow expertise to assume broader operational responsibilities. Such general manager training customarily focuses on achieving commercial goals in different environments.

- But, with careful board oversight, the CEO and other top business leaders must institute management development processes for corporate P&L and functional leaders that, at early stages in their careers, put strong emphasis not just on developing specialized expertise or on achieving commercial goals but on developing the experience and skills to do this through balanced risk-management and performance with integrity. This emphasis on risk management and an integrity culture should be a talent-management imperative as individuals rise within the corporation and face increasingly broader challenges requiring integration of all three dimensions of corporate mission.

- Such development will involve *broadly and different educational courses offered by the corporation during an individual’s career on the interrelationship between performance, risk and integrity in the context of a global society. Such courses may be offered inside the company or in executive MBA or executive education programs—but a rethinking of such courses, both in the company and in academia, may be necessary, given a broader definition of the CEO and business-leader role and the robust debate about necessary changes in business education as a result of recent business failures.*

- Such leadership development will also entail *giving high-potential individuals a broader range of assignments earlier in their careers—e.g., working on a team scrubbing a new product line for its risks; being integral to a major internal investigation of potential wrongdoing; helping to ascertain the geopolitical issues, as well as the business issues, in locating a new manufacturing facility in one of three or four Southeast Asian nations; assessing supply-chain risks and opportunities—and third-party suppliers—in emerging markets. Establishing the theory and practice of systematically implementing cross-functional assignments for up-and-coming leaders is a vital role for the CEO and senior HR leader working with the management development and compensation committee of the board of directors.*

3) **Refocusing the Process for CEO Selection—and for Other Promotions into High Corporate Positions.**

The ultimate result of the initial tasks—redefining the mission of the company and the CEO and revamping leadership development—should be a CEO-succession
process which expressly searches for and then selects a new leader for the company whose personality and career reflect the combination and integration of the necessary performance, risk and integrity dimensions.

- As it begins this succession process, the board of directors should restate and reiterate the mission of the company and the key characteristics of balancing risk taking with risk management and fusing high performance with high integrity in a company-specific articulation of purpose aimed at both inside and outside audiences.
- In exercising this function—which has historically (and properly) been viewed as its most important task—the board should hopefully (ideally) be able to choose from a strong talent pool inside the company.
- Similarly, promotions to senior corporate leadership jobs which the CEO recommends and the board of directors approves should be awarded to individuals who have the broad constellation of talents and skills required by the contemporary corporation with a redefined mission.

The need for core economic performance skills—financial, commercial, operational, strategic—are as important as ever in the CEO and top business leaders. Nothing said here is intended in any way to diminish the primacy of high economic performance in a business organization. But failures of business leadership in the recent past have frequently been due to serious weaknesses in risk assessment and management, or to serious lapses in adhering to legal, financial or ethical standards.

These failures have had significant, even catastrophic, impacts on shareholders, creditors, employees, customers, suppliers and communities. They have, over time, eroded the trust upon which successful conduct of business depends. A contemporary CEO must have proven skills in risk management, in creating a culture of integrity and in understanding business-in-society issues which pose both threats to, and opportunities for, the corporation. Strength in commercial operations and strategy is absolutely necessary, but not sufficient, in today’s business environment.

4) **Reformulating Operational Objectives for Performance, Risk and Integrity.**

How the company measures commitment to its fundamental mission over the short, middle and long term is, of course, a critical task in driving desired behavior and setting the terms for corporate accountability. Boards of directors and business leadership must together define a concise, comprehensive and robust set of operational objectives across the dimensions of economic performance, risk management and high integrity which can be clearly communicated inside and outside the company. Some will be enduring, like fundamental systems and processes. Others will need modification as the competitive, regulatory and geopolitical landscape changes.

This annual process of translating the broad articulation of mission into operational objectives requires great care and sustained attention. It should measure both financial and non-financial factors. It must become a core feature of the board/business-leadership relationship—a joint “deliverable” at the end of one year to provide an accountability test in the next.

Some important, illustrative measures follow. Each company will, of course, explicitly articulate and clearly explain the ones which it chooses to use because each, by itself, can create or hide problems.

a. **Sustained Economic Performance.** These measurements should be insulated as much as possible from book-keeping manipulation and short-term stock price fluctuations.

- The efficient use of capital through such measurements as return on assets and return on invested capital.
- Operational excellence as reflected in cash flow or operating margins or productivity increases.
- Strong connections to customers, through such measures as: market share, increases in revenues, repeat customer percentages, assessments of customer satisfaction, new products as percentage of offerings, brand strength.

For all the past focus on shareholders, the core activity of the corporation is selling quality goods and services to customers, the
stakeholders upon whom the company truly depends.

- Employee motivation, satisfaction and individual productivity.

- The more traditional performance measures of net profits, earnings per share, stock price increases, total shareholder return and return on equity. While these metrics of economic performance should not overwhelm all others, they will continue to be important. One of the challenges is how to give them their due, not make them dominant and thus put them in context with the many other measures of performance which make for a strong, growing company.

- How, and to what degree, changes in new technologies, new products, new acquisitions (or dispositions) and new geographies positively impact economic performance.

- Performance against peer companies in all the measurements mentioned above whenever possible.

b. **Systematic Risk Management for Economic Performance.** Risk disciplines must be matched with decisions about setting and implementing economic performance objectives. This Policy Brief discusses, in this section, direct economic risks relating to capital adequacy, leverage, liquidity, interest rates, currency, credit-worthiness of counterparties, products and operations. Other critical risks which can indirectly affect economic performance such as legal, reputational, ethical, IT, supply chain, country and geopolitical issues are discussed in the next section (on integrity measurements and processes).

The goal, of course, is not to eliminate economic risk taking—risk is the very nature of business. Indeed, the drumbeat of risk discussions in the recent past, while understandable, should not obscure the essential role of business in creativity and innovation. Rather the purpose is to understand risks to the extent possible, mitigate to the extent practicable and to ensure that there is adequate spread of risk so if large known or unknown adverse events occur the company is protected, not from decline but from destruction.

A prefatory note on risk organization: there are many different ways to organize risk functions both inside the company and at the board level. This Policy Brief does not attempt to say what is the best organizational form. That will depend on company mission and culture. As indicated below, it does say that, inside the company, there need to be independent experts on various direct and indirect economic risks. At the board level, each of these independent company experts should be directly connected to a committee (be it Audit, a new Risk Committee or a Public Affairs or Public Responsibility Committee). Ultimately pulling all the threads of risks together for the enterprise is, however, the responsibility of the CEO (the “chief” risk officer in a very real sense) and of the board of directors as a whole.

i. **Within the company**

- Inside the company, the economic risk function must be independent of operational business leadership. It must have direct access to the CEO—and, on highest priority matters, to the board. Assessing whether such an independent risk function exists, the quality of its people, and where it reports are all part of a risk measurement process.

- The fundamental job of financial risk management directed at economic performance is to assess major, direct and discrete economic risk dimensions of the firm—e.g., capital, leverage, liquidity, credit, currency, market, operations—through process-mapping, identification of important risk areas, and development of risk-mitigation measures and controls. Activities covered range from new products, to new geographies, to new customers, to major areas of existing operational exposure. Companies must also rigorously assess off-balance-sheet risks as part of this activity. These fundamental risk systems and processes can be assessed and measured.

- As a matter of business decision-making, the risk function should have an opportunity in
front of top leadership (separate from the business leaders proposing a course of action) to present important issues. The risk function doesn’t make the decision: top business leaders and (on high priority matters) the board of directors must expressly balance well-articulated reward and risk. But boards and top business leaders must understand as clearly as possible not just the rewards, but also the risks through candid, systematic presentations by those expert in risk. A healthy, candid debate is critical. Again, it is possible to assess whether such interaction took place during the course of the year on the right set of priority issues.

• Risk management must also ascertain the systemic risk to the corporation from the combination of financial, commercial and operational risks. Without entering the voluminous and spirited debate about mathematical risk models, it is fair to say that, while they have utility in measuring some types of systemic risk, they are not better than their assumptions and the past data from which they are constructed—which can well be inadequate in times of future stress or dislocation. Systemic risk assessment involves some scenario-planning around worst-case critical issues—such as leverage, liquidity, currency, credit and operational risks—including those occasioned by major global economic dislocations.

• The company must decide how to spread risk prudently so that even an unknown, low-probability event in a particular area or activity cannot sink the company. Articulation of this spread-of-risk philosophy and adherence to it is also an important risk objective.

• Similarly, the company should institute early warning systems on economic risks—whether in regular valuation of assets, or changes in markets, or unforeseen moves from competitors—which trigger a high-level discussion of risk-taking/risk-management issues that could lead to changes in course.

ii. At the board committee and full board level

• There should be a board entity—whether the Audit Committee or a new Risk Committee—which has the task of assessing the direct economic risks noted above (capital, leverage, liquidity, credit, market, operational) confronting the company. Working with management, it should review and agree upon the fundamental systems, processes and measures for assessing, mitigating and monitoring risk, as described immediately above. It should receive timely updates on the status of high risks facing the company. It should also receive reports from relevant risk officials in a company on whether those receiving compensation above a certain level have identified relevant risks and taken appropriate risk-mitigation steps. (This activity is relevant both to accountability and to compensation.)

• Ultimately it is the job of the full board to understand the work of the business leadership and the risk/audit committee on the assessment and management of the high-priority risks associated with economic performance which can seriously injure the corporation. Significant allocation of its limited time should be devoted to this subject of priority risk issues.9

c. Promoting High Integrity and Assessing Legal, Country and Geopolitical Risk. A major change for many corporations would be to be explicit about measuring business leaders on creating a culture of integrity, as defined above (law, ethics, values), and assessing integrity risks as systematically as the corporation reviews economic risks.10

i. Inside the company

• A company can measure the integrity promotion efforts of its CEO and other senior executives across at least five dimensions. Have leaders:

—adopted key principles such as consistency and commitment in both words and actions; embedding integrity disciplines in business operations; having systematic processes for surfacing, analyzing and deciding ethical issues; giving employees voice to express concerns; protecting company security?
—adopted key implementing practices to make those foundational principles a reality (risk assess/risk manage fundamental business processes intersected by variety of legal requirements; insure that systems for preventing, detecting and responding to integrity issues are robust across businesses and geographies)?

—created an affirmative culture of integrity where employees are not just afraid of violating rules but affirmatively want to do the right thing? Culture can be assessed by a number of techniques, including anonymous internal surveys, external reputational surveys and 360 evaluations of key leaders.

—performed well against peers (comparisons to other divisions inside companies or to external peer companies, in, for example, environmental compliance)?

—established and met annual goals and objectives (how are hard problems handled, key people hired, identified weaknesses remedied)?

• As with financial, commercial and operational risks, companies should establish “integrity” early-warning systems to identify important, emerging risks which can have indirect economic impact (as well as other adverse effects):
  —Changes in broad public-policy architecture (e.g., tax, trade, environment, health care etc.).
  —Changes in important but more fine-grained legal or financial rules that can have a significant impact on the company.
  —Changing ethical expectations and demands.
  —Security threats to people, facilities, information and supply chain.
  —Changing geopolitical or country risk. In particular, an understanding of geopolitical context is critical because low-probability but high-impact events (military action, currency devaluations, political upheaval) can, of course, have dramatic impact on business operations.

Properly designed, such early warning systems gather information systematically and present issues on periodic basis to business leaders for decision. Is detailed analysis beyond issue identification needed? Business leaders must decide. If so, should the business take anticipatory action to get ahead of the curve (e.g., adopt consumer protections in financial services to anticipate regulatory change and avoid enforcement actions and consumer law suits)? Both the process (does every appropriate business unit have such processes relevant to their product mix?) and the results (were challenges anticipated, if not why not?) can be assessed.

ii. At the board committee and full board level

• As with financial risk, a committee of the board of directors should be responsible for reviewing and agreeing upon the fundamental measures for promoting integrity and the systems, processes and measures for assessing, mitigating and monitoring integrity, country and geopolitical risk. As noted at the outset of this section, whether this is the Audit Committee, a special Risk Committee or a Public Responsibilities or Public Affairs Committee will turn on each company’s culture. (Joint committee meetings may be appropriate on such topics as country or geopolitical risk which have multiple causes and impacts.)

• Finally, as with economic performance, it is ultimately the responsibility of the full board to oversee basic integrity risk-mitigation systems, processes and priority results and assess whether an integrity culture exists.

In sum, these basic operational goals and measurements across performance, risk and integrity dimensions are essential for allocating responsibility and ensuring accountability inside the corporation. But they also should provide a public template for accountability that is a meaningful alternative to the reductionist, at times misleading, metric of short-term share price as indicator of company value and performance.11 (See page 11 for discussion of a need for corporations to articulate these operational goals publicly in order to fix their responsibility and accountability.)
5) **Revising Compensation for CEO, Senior Executives and Other Key Employees.**

A revised approach to compensation flows from a redefinition of the CEO role, revamped leadership development, a new process for CEO selection, and development of broader operational objectives to hold executives accountable. It should reinforce and be reinforced by those other tasks. The broader purpose is to change compensation based on short-term results that ignore long-term risks and to use compensation to incentivize short, medium and long-term value creation attained with sound risk management and with high integrity. The purpose of compensation is, of course, to attract and retain talent, but within that balanced framework. Select companies are moving explicitly in this direction.12

The setting of compensation for the CEO and top business leadership is a fundamental role of the compensation committee and then the full board. But, development of the overall compensation philosophy and its application to top company talent should be a joint board and senior executive function.

This Policy Brief advances the following concepts for a revised approach to compensation. These concepts are consistent with those advanced in other recent analyses and reports as a consensus is beginning to form on new pay principles (if not yet on critical details and methodologies).13

- Compensation for the CEO and top business leaders should turn on actions and results in the three separate operational areas comprising corporate mission: sustainable, durable economic performance; effective risk assessment and mitigation; and promotion of an integrity culture through systems and processes embedded in business operations. Each should be a discrete element in a comprehensive pay regime which then uses them in combination to determine total awards.

- Although top business leadership will receive substantial annual cash compensation, significant compensation in a particular year will be variable cash and variable equity which will be paid out or held back over time as performance, risk and integrity objectives are met, exceeded or missed. These objectives should generally reflect relative effort of leaders—compared to past results within the company (positive or negative trends) or against peers or both. Deferred cash has the advantage of avoiding stock price manipulation and providing necessary liquidity to individuals. Deferred equity has the advantage of tying employees to the long-term creation of shareholder value.14

- Variable cash granted in a single year will be some multiple of annual cash and should be paid out in increments on a multi-year schedule. Some misses due to negligent or intentional acts—a significant misstatement of financials upon which company results were based or a serious failure to weigh risk or a major integrity lapse—can lead to complete cancellation of the variable out-year compensation. Others misses due to serious, avoidable mistakes may lead to a diminution but not cancellation of variable compensation.

- Variable equity should also be granted in one year but only vest in out-years depending on attainment of performance, risk and integrity measurements, although the mix might be tilted more to balanced economic performance (in the different categories summarized above, efficient use of capital, operational efficiencies, relationships with customers etc). Stock price increases and total shareholder return should be a factor but not the factor.15

Again, these performance options or RSUs should be withheld or clawed back for serious negligent or intentional acts similar to the cancellation of variable cash grants. So, too, lesser mistakes may lead to diminution, not cancellation. To minimize manipulation of business for short-term stock gains even in the out-years a holding period, beyond the vesting period, may be appropriate.

- Variable cash and variable equity awards may also be designed in the year they are granted with incentives for sustained performance in the out-years. For example, if future operational objectives set in year one are exceeded in subsequent years, then cash and equity awards from year one which are vesting in those subsequent years could be increased.

- In cancelling variable cash or variable equity awards for performance, risk or integrity misses due to negligent or intentional acts, boards should
utilize “hold-backs” and “claw-backs.” A “hold-back” occurs during the vesting period of the award: the cash or equity never goes to the recipient. A hold-back occurs at the discretion of the company, and employees have to bring an action if they believe the corporate action was improper or unfair. A “claw-back” occurs after the vesting period and requires some type of formal company action to demonstrate that clearly articulated standards triggering a claw-back were breached.

• Similarly, compensation plans must risk assess jobs below the top business leaders and apply new compensation design for individuals, not just top officers, with the ability to commit resources with significant long-term opportunities and risks for the corporation (e.g., those who sell instruments creating long-term obligations for the company). Compensation design will turn on specific performance, risk and integrity parameters applicable to those individuals. But, the variable cash and equity compensation will outweigh annual cash compensation. Here too, the board should have the power to hold-back or claw-back variable cash or equity for negligent or intentional misses within a defined sphere of responsibility, as well as providing for diminution or augmentation of target compensation in the outyears depending on enhanced or poor results.

• But, even for those individuals important to company performance, compensation should have an important element built on company and division results, not on solo contributions alone, to help create a strong and loyal culture.

• Application of these principles would sharply reduce two problematic compensation mechanisms which, in the view of a number of commentators, drove short-termism and excessive risk-taking:

  — the “naked” stock option which rewards a simple increase in share price disconnected from attainment of priority operational goals; and

  — the huge annual cash bonus awarded without regard to risk consequences in the out-years.

• Such a compensation redesign—like establishing measurements for risk, performance and integrity accountability—requires new thinking and hard work.

— One problem is devising multi-factor measurements (performance, risk, integrity) in the right proportions that reflect the mission of the company but are not so complex as to be confusing or opaque nor so simplistic as to be a distortion of reality.

— A second difficulty is ascertaining when company leaders or individual performers have made a difference by their efforts—the kind of differentiation which should be at the core of all compensation—or whether exogenous conditions have affected results, either on the positive or the negative side. Leaders and key employees should not be penalized for events beyond their control, but neither should they be rewarded excessively for such occurrences.

— A third critical issue is pay equity (which has drawn tremendous fire in the financial sector): both the absolute amount and the amount relative to other key personnel inside the corporation. Companies need to face into the question: how much is too much?

All these issues should be addressed in a revised compensation regime.

• The revised approach to compensations should be communicated in clear, understandable terms to shareholders and others. Meaningful, nuanced discussion with appropriate groups about the approach to compensation, including but not limited to shareholders, is more important than a blunt “advisory vote” of compensation philosophy, measurements and results at shareholders’ meetings.

6) Re-aligning the Board’s Oversight Function.

The critical oversight function of the board of directors should be aligned with the performance, risk and integrity measurements which indicate whether the company is attaining high performance, sound risk management and high integrity and which will be used in delivering compensation to the CEO and top business leadership over a multi-year period.

This alignment should help directors focus, in their limited time, on what is essential.
• Properly seen, “strategy” from the board perspective is not just commercial strategy, but the most important performance, risk and integrity issues facing the corporation both in the coming year and over a longer-term planning horizon (3-5 years?).

• At the end of each calendar year, the CEO and top business leaders should present to the board of directors a list of key performance, risk and integrity issues. From this list and from their own assessment of corporate challenges, the board will choose the priority board meeting issues for the coming year. This choice will set the core board agenda, subject, of course, to the emergence of new high-priority issues. A robust director discussion of these possible priority issues, not just a quick rubber stamp, should occur at this critical end-of-year event.

• The independent board chair or presiding director will ensure that these issues are, in fact, covered in depth during the course of the year and that the core trade-offs and considerations are fairly and candidly discussed with the board (whether in written materials, oral presentations or some combination). Requiring boards to give approvals or considered views on hard issues after just one meeting should be resisted. Structuring sequential discussions of complex and important issues over several meetings may help the board more fully come to grips with priority matters. The board’s task is to review, appraise, critique and enrich the analysis and decision relating to these issues.17 The business leaders should strive to present the board with high-quality information focused on the priority issues and the real choices or options. Quality, not quantity, and absolute candor on the hard issues, not vague descriptions of the decision, should be the touchstones.

• At the end of each year, the CEO and business leaders should prepare a report for board of director’s review on how the company has performed on the various measurements—and whether, in light of experience and emerging developments, the measurements for the following year should be modified. Such a systematic review, coupled with the agenda-setting exercise for subsequent board meetings, can require significant board attention in the fourth quarter both to assess the current year and to plan for the subsequent one. It is hard to imagine a better use of board/management time. Such a review may also require intense discussions between the board leader and the CEO in advance of the board meeting to improve the candor and completeness of the presentation.

• To increase accountability, the board of directors and business leaders could consider how to make a report available to the public which in clear, concise form discusses the record of the year against operational goals—and the operational goals and issues for the following year. At present, discussions at end-of-year analysts’ meetings, in Proxy Statements (e.g., on executive compensation) and in Annual Reports (CEO letter/Management Discussion and Analysis) may not present a clear, comprehensible account—in plain, understandable language—of past goals, present record, future goals. A new joint Board-CEO statement or recasting of the CEO’s letter to the shareholders in the Annual Report could constitute such a “plain English report.”18

Carrying out these six foundational, interrelated governance tasks is the core of a right-sized, critical but constructive relationship between a corporation’s board of directors and its CEO/senior business leadership. Carrying them out well should help create a strong, durable growing corporation—and could address the current crisis of confidence in the governance of corporations.
Boards of directors and business leadership must honestly confront key obstacles to this basic reorientation of corporate governance. A brief enumeration of salient problems follows, which is intended to raise issues for further discussion, action, research and analysis.

1) **Labor Markets.** Can individual corporations which define short, medium and long-term performance, risk and integrity operational objectives—and base significant deferred compensation on their attainment—compete in the labor market for business talent? Other business entities willing to use large amounts of cash and options, with fewer pay-out requirements, may seek to attract top leaders and performers in a very competitive labor market.

—One approach, beyond individual firm initiatives and well short of comprehensive public regulation, is for corporations in a particular industry group (or in a more general business association) to develop a code of compensation principles (in a manner that must avoid antitrust concerns). A corporation’s commitment to such a code and subsequent implementation could be reported in sequential Proxy Statements. Such codes must have principles which are specific enough to guide action. They must also avoid “leakage” either through an inability to ascertain clearly whether signatories are keeping their commitments or through the refusal of peer entities to sign up in the first place.

—A less difficult, more traditional approach is to rely on institutional loyalty spawned by strong leadership. Such leadership can create exciting, empowered, growing corporations serving customers with great products and services and meeting fascinating challenges in the global marketplace. Many people have important values, other than money, that need to be served in an institution—and great leadership can make those values come alive, can create loyalty and can, thus, attract, retain, promote and challenge outstanding individuals from all over the globe. For those employees motivated solely by greed, little can be done by an individual firm dedicated to the changes in measurements and compensation described above.

2) **Differing International Standards.** Because of its centrality to the effective functioning of the global economy, the financial sector is the subject of procedural or substantive regulatory debates addressing some or all of the governance issues raised above—as well as important questions relating to broader issues of safety and soundness. (See note 1.) For example, the G-20 recently announced a set of broad principles covering risk and compensation practices which should be subject to national regulation. But, the prospects for genuine harmonization of national laws—or even significant convergence—are mixed, at best. Until that happens across major capital markets, there is a genuine risk that companies or talented individuals in the financial sector will take advantage of “regulatory arbitrage” to avoid governmental pressures for the types of changes outlined above, even if those changes are undertaken voluntarily by financial institutions. Similar regulatory arbitrage may occur with non-financial public companies as a result of different regulatory regimes across the globe relating to governance (and other impactful) regulatory issues.

—Companies concerned about the issues in this Policy Brief need to consider political action in their major markets to urge as much uniformity as possible. Such political action could be directed at regulation which they believe is a necessary floor under private action. But it could also be aimed at regulations with which they may differ but which will have greater adverse impact if lacking in uniformity (e.g., capital requirements or liquidity protections).
3 Change in Board Compensation Advisors. Many compensation advisors to boards are expert in comparing executive compensation delivered at one company to compensation delivered at “peer” companies. They are expert in designing various mechanisms for delivering that compensation—salary, bonus, deferred salary, deferred bonus, stock options or restricted stock units. But, for boards of directors to revise compensation of senior executives and to oversee broader company compensation regimes, they need their own advisors with additional expertise. Many reports focus on the advisers’ independence. That is important. But a revised skill set is of equal importance.

Compensation advisors to boards need to have a detailed understanding about how the company works in the context of global markets and global society so that they can help the board have its own perspective, when working with management, to define the operational performance, risk and integrity objectives which are appropriate to the company and upon which a revised compensation regime must be built. Finding such an advisor—with business as well as compensation expertise—may require boards to go beyond the traditional compensation consulting firms. Eventually, a new cadre of independent consultants can emerge, but only if boards of directors make clear that they want advisors who can help analyze the business goals which must necessarily precede compensation sound design.

4) Short-Termism of Institutional Investors. Perhaps the most difficult of these difficult issues is how do corporations resist the short-termism of certain, important institutional investors? Such investors today own more than 60 percent of U.S. equities and drive the direction of the stock markets.

Institutional investors—whether traditional ones like pension, insurance and mutual funds or newer more ones like hedge funds or micro-second traders—may be primarily, even exclusively, interested in short-term profits to beat composite benchmarks or to attain highly remunerative “2-and-20” absolute returns. Individual investors place their funds with institutional investors and are likely to care more about how the institution manages their money, than about the underlying performance of the companies owned by various funds. There is now substantial debate about whether (or over what period) the stock market accurately reflects the “value” and “performance” of a company, especially as the average holding period for equities is now less than a year.21

These financial intermediaries can create pressures for behaviors that are not in the interest of sustained value creation. Indeed they can injure the company by forcing bad business decisions (ill-considered risk-taking, improper leverage to boost earnings temporarily, deferred investments or maintenance costs, delay of R&D) or by creating pressures for illicit ones (fraudulent accounting, improper payments). These intermediaries may care little for a corporation’s other stakeholders who have a long-term financial interest in the company (e.g., long-term shareholders, creditors, employees, customers). Although empirical research is needed to understand their impact on the market in near, middle and long-term time periods, there is little question that institutional investors with a short-term orientation are an increasingly powerful force in the equity markets.

Two seasoned observers describe the problem. In a new book, economist Henry Kaufman says: “Most investment relationships today are very fickle. Portfolio performance is measured over very short-term horizons….Day trades and portfolio shifts based on the price momentum of the stock—rather than anything having to do with the underlying fundamentals—are commonplace.”22 Ira Millstein, a pioneer in the governance movement and proponent of shareholder voice, has recently expressed similar views.23 So have the Federal Reserve and regulatory bodies in Europe.24

One answer is to begin a much closer examination of the governance of these various types of institutions, the compensation of fund managers and the need for greater transparency.25 But, given the variety of institutional investors, it may be a long process to evaluate governance, fund manager incentives, the different market impact of different types of institutional investors and, ultimately, whether any private or public, substantive or procedural, “governance” reforms are necessary or appropriate.
—A second response is to consider adjustments to current tax and other public policy provisions which may promote short-termism.26

—A third approach is for boards and corporate leaders to resist strongly the claims of “short-termers” where, in the best exercise of their judgment, actions to pump up short-term earnings and stock price would be harmful to creation of long-term value. In standing up in such circumstances, business leadership needs to establish meaningful engagement with other investors who have a longer time-frame, either to secure support for the corporation’s mission, objectives and method of compensation or to make appropriate changes such long-term investors suggest. Obviously, companies talk with major shareholders and hold analysts’ meetings. But it is worth examining whether this process can be enhanced by more complete, transparent discussion of the six seamless tasks with advisory councils of shareholders, consistent with the strictures of fair disclosure to all investors. A question of great moment is whether those longer-term investors concerned about durable growth of corporations can counter the influence of other financial intermediaries focused only on market movements and their own short-term profits.

—The United Kingdom is considering transformation of the third approach into a more formal “stewardship code” for fund managers which, among other things, establishes best practices for institutional investors that choose to engage in discussions about long-term strategy (at times collectively) with companies in which they invest (while not precluding a “sell” decision if that is deemed the most effective response). Under this proposed regime, institutional investors choosing not to comply with the “stewardship code” would need to explain their alternative business model and reasons for not subscribing to the “stewardship” code.27

5) Manipulating the Numbers. While it is important to translate a redefinition of mission into operational financial and non-financial objectives across performance, risk and integrity dimensions, these measurements must be meaningful and carefully implemented. While it is true, as a general matter, that measurements drive behavior, it is also true, that, when consequential, there is always pressure to manipulate the measurements to hide non-performance.

—Boards of directors and business leaders must use audits and other checks and balances to ensure that measures are milestones on the path to corporate virtue not numbers to be “gamed” on the road to corporate hell.

6) The Reduction of Pressure for Change. Although effects of the credit crisis, the deep recession and high unemployment are likely to remain for some time, signs of bottoming out or of nascent recovery may remove pressure for regulation which is always at its height when circumstances are at their worst. And the threat of new regulation is one of the drivers for private-sector change. Will companies still face into the need for re-evaluating and possibly revamping the essentials of governance as the recovery grows in strength?

—All companies, even (or especially) well-managed ones, should view this period of economic discontinuity as an appropriate time to review the fundamentals of what the corporation stands for and what are its core governance tasks. In fact, improvement in the economy, however slight, may lessen the need for full-time crisis management and free up time to address these foundational issues.
The crisis of confidence in corporate governance leads to the ultimate governance question of how boards of directors and business leaders are held accountable. Although a number of mechanisms exist, they all lead back to finding boards of directors and business leaders who can create sustained economic value for shareholders and other stakeholders with high performance, sound risk management and high integrity.

This is so because, while the main accountability mechanisms have strengths, they have also have limitations.28

1) **The Market.** One answer to the accountability question is stock price. Maximization of shareholder value has been seen as the ultimate goal of the corporation and thus the measurement by which boards and senior business leaders are held to account. As discussed, the events of the past two years have raised important questions about “efficient-market” and “rational-choice” theories which posit the market accurately assesses the value of the company. An important question is “when” is the market yielding the “right” valuation answer, given, among other things, the rise of short-term institutional investors, the asymmetry in information as companies and products become more complex, the possibility of non-rational or irrational behavior at any point in time and the periodic creation of bubbles.29

—So, even to say that the “long-term value” of a company’s stock is an important way to measure accountability is to raise questions. What is “long-term?” Is a changed valuation in out-years a steady trend over time or simply a “short-term” valuation at some future point? In light of the widely divergent institutional investor time frames, objectives, products, risk appetites, incentives, governance structures—and the irrationalities and inefficiencies of the market—there are serious and intense debates in the business, economics and finance communities over whether, when and to what degree stock price is the proper measure for holding companies accountable.

2) **Shareholder Involvement.** A second answer to the accountability question is more shareholder involvement in the governance of the company. Such involvement can be imposed by regulatory entities (federal government, states, stock exchanges) or adopted by the company itself (through voluntary changes or through responses to shareholder votes). One type of change is aimed at enhancing shareholder “advisory” voice. Recent examples are, of course, “say-on-pay” shareholder advisory votes and attempts to make it easier for shareholders to call a meeting. A second is directly to affect the election of directors. One recent example is the requirement that directors who receive less than 50 percent of votes cast should resign (or be removed from) the board. Another long-standing and controversial issue involves “ballot-access” proposals which would make it easier for dissenting shareholders to put a director nominee up against the board’s own slate in the election of directors.

—Of course, as noted, there is no such animal as a “shareholder.” Instead, equity owners are a menagerie of the individual and institutional; the short, long or both; the technical or not. Whether shareholders are part of the solution (because boards can be complacent and self-perpetuating) or part of the problem (because of the short-termism of important institutional investors disconnected from any concern about the fundamentals of the underlying company) is also a subject of spirited debate regarding shareholder “voice,” “access,” and, of course, the rules governing takeover and control, the ultimate exercise of shareholder power.

3) **Government Regulation.** A third accountability mechanism is government regulation, where public decisions limit the discretion and self-governance of private corporations. Such limitations in our “mixed” economy have, of course, existed since the 19th century and have covered a wide array of issues from taxes to disclosure to listing requirements to environmental health and safety.
Today, in the case of financial institutions, global regulators are considering a number of substantive requirements, which would limit business decision-making: e.g., counter-cyclical capital requirements, liquidity protections, accounting standard revisions, credit agency reform, regulation of complex products, authority to address systemic risk, and special oversight for large complex organizations. Similarly, with respect to all publicly held companies, various procedural/disclosure requirements are also under consideration, such as increased transparency about how risk is managed and how compensation is designed in order to discourage "excessive" risk-taking. Organizational mandates—such as a "risk-committee" requirement—are also being considered.

—Here, too, there are sharp debates about: the shape of regulation, its effectiveness, its possible unintended consequences and its impact on the necessary innovation and creativity which drive companies and the economy.

* * * * *

4) Back to the Future: The Duties of Boards of Directors and Top Business Leadership. At the end of the day, this Policy Brief notes these important accountability mechanisms, and some of the key issues they raise. But, because of its focus on self-governance, it does not address the debates swirling around them. Instead, it stresses that the goal of accountability mechanisms briefly described above (with a caveat about short-term investors disinterested in company fundamentals) is, or should be, a board of directors and top business leadership that discharges the six seamless tasks with vision, energy and effectiveness to create long-term value for shareholders and stakeholders.

The stock market, the shareholders, and the government cannot lead and manage the corporation. The ultimate accountability—and responsibility—still lies with the senior executives and an engaged board of directors. This is so for traditional but still fundamental reasons. Corporate decisions require judgment in making the inevitable trade-offs. Only management, under board oversight, can effectively implement the corporate mission. Indeed, outstanding leadership from boards and business leaders answers the problems which the other accountability mechanisms seek to solve—outstanding leadership, not complacent, self-protecting boards.

But, as this Policy Brief has argued, boards of directors and senior executives must explicitly address this fundamental issue of accountability. Accountability can be improved if corporate leadership focuses on the six seamless tasks and if it articulates, both inside and outside the company, a set of performance, risk and integrity operational objectives which are clear and understandable and against which boards and senior executives can be measured and held responsible. Such measures flow from a redefined mission which shapes leadership development, CEO selection, and definition of operational objectives. These tasks, in turn, focus executive compensation on the right issues and re-align board oversight on the right priorities. Candor in assessing how the company is doing in relation to its key operational objectives is essential to accountability—and to creation of trust.

In this turbulent era, when debates about the role of market prices, shareholder actions and government regulation are on the front burner, it is vital that boards and business leaders step up to the questions about the capacity of corporations to govern themselves effectively.

Many reports, like this one, address hard problems, with deep structural roots, by calling for leadership. Too often that plea goes unanswered—or the structural problems are too intractable. But today, with a governance crisis in confidence, it is in the interest of corporations and of capitalism itself for people in leadership positions truly to address the governance problems of the era and to provide a clear, credible and powerful private sector response.
1 In focusing on self-governance issues, the Policy Brief does not intend to minimize the importance of the public policy debate on how to assure the safety and soundness of financial institutions in the future through regulation of such issues as capital requirements, liquidity protections, systemic risk, special regulation of large financial institutions, rating agency reform and reform of accounting standards.

Similarly, the Policy Brief does not argue the pros and cons of, nor minimize the potential importance of, more general governance public policy issues which are currently the subject of legislative or regulatory debates: e.g., compensation (say on pay, clawbacks, no severance for poor performance, independence of compensation committee, independence and disclosure relating to compensation consultants; disclosure of relation between pay and risk); director elections (proxy access, ban on broker voting, abolition of staggered boards, majority vote in uncontested elections); risk (creation of special risk committee; increased disclosure on risk); other (independent board chair; disclosure of reasons for board chair/CEO structure). The Policy Brief does address a number of these issues, but in the context of desirable corporate self-governance and self-determination.


4 See, Committee for Economic Development, Rebuilding Corporate Leadership: How Directors Can Link Long-Term Performance with Public Goal, (Washington, D.C.: CED, 2009). Corporate citizenship may be defined as having three elements: sustained and durable economic performance which benefits shareholders and other stakeholders; robust adherence to the spirit and letter of formal rules; ethical actions and shared values beyond what the formal rules require that are in the corporation’s enlightened self-interest. This last element may involve voluntary actions taken by the corporation alone or it may involve positions taken on public policy in connection with other parties (not necessarily corporations alone) to secure a “social good” that is too costly or too difficult for one company and that fairly weighs public and private interests.


6 See generally, Committee for Economic Development, Built to Last.

7 Of course, as with all measurements, an over-emphasis on one may cause unwanted distortions. For example, return on equity has been sharply criticized in the financial services sector because that metric is higher when debt is higher. Return on assets may prompt off-balance sheet activity. Increased market share may come at the price of margin. And even peer-to-peer comparisons may be misleading if whole industries are making the same mistake (e.g., leverage in financial services companies). Thus, articulation and explanation of key metrics is important both for sound operations and for generating the trust so important to corporate health.

8 Some of the common economic risk problems—which have been highlighted in the last year and apply to all corporations, not just financial institutions—should receive special and continuous attention: lack of liquidity if in thinly traded markets; too much leverage; assumption of market certainties (housing always goes up); failure to control small unit with capability of creating big risk; securitization that hides risk and pumps up profits; use of badly designed, ill-understood products; lack of stress-testing for major dislocations; lack of disclosure and transparency to senior leaders and the board (let alone to the public).
9 Companies are designing structures and processes for managing economic, legal, ethical, reputational, public policy, country and geopolitical risks in different ways. Different specialists—and different organizational entities within the company—may address different types of risks. As noted in the text, this Policy Brief takes no position on the desired way to organize risk inside the company beyond the principles stated above. Best practices at a more detailed level will emerge from experience.

10 For a more extended discussion of the integrity practices and principles that can be built into compensation regimes see generally, Ben W. Heineman, Jr., High Performance with High Integrity (Boston, Ma; Harvard Business Press, 2008).


13 See notes 2 and 3, supra.

14 The total of variable cash and variable equity may well be larger than fixed annual cash. The proportions between variable cash and variable equity will depend on company culture and the advantages of liquid incentives (variable cash) or incentives tied to stock (variable equity which may rise or fall relative to strike prices for reasons which may not relate directly to company performance). Both should be strongly linked to attainment of operational objectives across redefined economic, risk and integrity dimensions; by so doing, both should promote creation of long term value.


16 Designing hold-backs and claw-backs, where benefits are withheld or pulled back because of serious negligent or intentional acts (of commission or omission) is a complex subject, beyond the scope of this policy brief. Issues include: defining acts which will give rise to holdbacks/clawbacks (financial misstatements or a broader array of material performance, risk and integrity issues). If the individual is an executive when is he or she responsible for the bad acts of people working for them? Who in the employee population will be affected? For how long does the employee remain exposed to hold-back/clawback provisions? What process is due the employee; how will the provisions be enforced?

17 Committee for Economic Development, Built to Last.

18 Such a summary statement must, of course, comply with legal disclosure requirements. It may have to be issued in the first quarter of the subsequent fiscal year after issuance of the 10-K, the Proxy Statement and the Annual Report and, as appropriate, incorporate by reference.

19 Statement of the G-20 Leaders, September 26, 2009. With respect to compensation at relevant regulated financial institutions, the G-20 endorsed implementation of certain Financial Stability Board standards, such as "requiring a significant portion of variable compensation to be deferred, tied to performance and subject to appropriate claw-back and to be vested in the form of stock or stock-like instruments, as long as these create incentives aligned with long-term value creation and the time horizon of risk." In the financial setting, the G-20 also endorsed the power of regulators to
set higher capital requirements when additional risks are created through failure to implement sound compensation policies. See section of Statement on “Strengthening the International Financial Regulatory System,” paragraph 13.

20 In a statement following its March, 2009 meeting, the G-20 emphasized that, even though new financial regulation was primarily a national responsibility, it had to be consistent across boarders: “Regulators must ensure that their actions support market discipline, avoid potentially adverse impacts on other countries, including regulatory arbitrage....” See, Francesco Guerrera and Megan Murphy, “Bankers Fear Transatlantic Pay Split,” Financial Times, October 29, 2009, available at <http://www.ft.com/cms/s/0/6b7688d6-c4c4-11de-8d54-00144feab49a.html>; Jeremy Grant, Tom Braithwaite and Aline van Duyn, “Cracks Are Emerging in Transatlantic Approach to Reform,” Financial Times, January 6, 2010, available at <http://www.ft.com/cms/s/0/ad574f78-fa62-11de-beed-00144feab49a.html>.

21 For example, average annual turnover in the NYSE Group has been over 100 percent and the average holding period a year or less since 2005. NYSE Group turnover is based on NYSE & NYSE Arca Average Daily Volume. See NYSE Facts & Figures, NYSE Group Turnover 2000–2009, available at <http://www.nydata.com/factbook>.


23 Ira Millstein and George Votja, “Financial Disaster Recovery: A Private Sector Agenda for Risk Management,” Directorship, December 2008/January 2009, p. 25. “The proliferation of new owners puts the model of shareholder activism, which was envisioned in the 1980s and 1990s, under severe strain. Institutional investors were once presumed to share a common goal when exerting pressure on boards to monitor management and effectively guide firm strategy. That assumed homogeneity now seems long gone, and heterogeneity is ever on the rise. This diversity of shareowners has brought a whole new host of agendas, strategies and values to the table. Some of these owners have limited investment horizons and are only interested in realizing a short-term profit, and others have hedged or shorted their positions and consequently have a financial interest in the failure of the enterprise.”


25 The Millstein Center for Corporate Governance and Performance at the Yale School of Management has a program on “Private Sector Architecture For Future Capital Markets” which raises questions like governance, pay structure, incentives, political influence—and role of both executives and fund managers—in major types of investors/financial intermediaries. See Milstein Center for Corporate Governance and Performance, Yale School of Management, “Pay, Risk and Stewardship.”

26 See Aspen Institute Business and Society Program, Overcoming Short-termism: A Call for a More Responsible Approach to Investment and Business Management. This analysis argues that adverse impact of short-termism in the stock market is serious: “In the absence of real change in the focus of institutional investors and related intermediaries, the various corporate governance reforms are unlikely to reduce the likelihood of boards and managers responding to short-term pressures.” The paper recommends, for example, creating a greater differential on taxes for short and long-term capital gains or removing the $3,000 cap on capital loss deductibility from income for longer-term holdings.
Endnotes


28  This concluding section focuses on the four “accountability” mechanisms: the market, shareholders as part of a governance structure (not just as investors trading in equities), government regulation and corporate leadership (boards of directors and senior business executives). One could, of course, unpack the concept of “accountability” and identify many more issues: the many different types of government regulation and enforcement, the many different types of private litigation, the accounting rules, the creditors, the credit rating agencies and the markets not just for the daily trading of equities, but for initial public offerings and for the ultimate shareholder-as-investor accountability mechanism, the battle for corporate control (obviously hedged in by various laws and regulations). The point of this section is that, whatever the purposes and effectiveness of these various accountability mechanisms, only the board of directors and top corporate leadership can, at the end of the day, build and sustain a corporation that properly balances performance and risk management in a culture of integrity.

29  See, note 15, *supra*. 
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# CED Counterpart Organizations

Close relations exist between the Committee for Economic Development and independent, nonpolitical research organizations in other countries. Such counterpart groups are composed of business executives and scholars and have objectives similar to those of CED, which they pursue by similarly objective methods. CED cooperates with these organizations on research and study projects of common interest to the various countries concerned. This program has resulted in a number of joint policy statements involving such international matters as energy, assistance to developing countries, and the reduction of nontariff barriers to trade.

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Name of Organization</th>
<th>Location</th>
</tr>
</thead>
<tbody>
<tr>
<td>CE</td>
<td>Circulo de Empresarios</td>
<td>Madrid, Spain</td>
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<tr>
<td>CEAL</td>
<td>Consejo Empresario de America Latina</td>
<td>Buenos Aires, Argentina</td>
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<tr>
<td>CEDA</td>
<td>Committee for Economic Development of Australia</td>
<td>Sydney, Australia</td>
</tr>
<tr>
<td>CIRD</td>
<td>China Institute for Reform and Development</td>
<td>Hainan, People's Republic of China</td>
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<tr>
<td>EVA</td>
<td>Centre for Finnish Business and Policy Studies</td>
<td>Helsinki, Finland</td>
</tr>
<tr>
<td>FAE</td>
<td>Forum de Administradores de Empresas</td>
<td>Lisbon, Portugal</td>
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<tr>
<td>IDEP</td>
<td>Institut de l'Entreprise</td>
<td>Paris, France</td>
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<tr>
<td>Keizai Doyukai</td>
<td>Keizai Doyukai</td>
<td>Tokyo, Japan</td>
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<tr>
<td>NBI</td>
<td>National Business Initiative</td>
<td>Johannesburg, South Africa</td>
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<tr>
<td>SMO</td>
<td>Stichting Maatschappij en Onderneming</td>
<td>The Netherlands</td>
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