THE CORPORATE GOVERNANCE ALLIANCE DIGEST

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Are You Standing Far Enough Away To See?

By Eleanor Bloxham

A man, a passenger, sitting in a convertible traveling at 60 miles an hour holding up a tennis ball, stationary, clutched in his right hand, will not observe what the woman standing on the side of the highway does: a tennis ball is traveling southwest at 60 miles per hour. When you are too close, it is difficult to see. Companies (and all their stakeholders) rely on boards to *not* get in the back seat, but rather stand on the highway and observe.

I'll be in New York at the June NACD Directorship forum. (Information on it here: http://www.directorship.com/events/tdfjune2010/) I hope to see you there.

Risk and Strategic Oversight: Governance is Key.

The fifth annual **Global Risks Report** of the World Economic Forum http://www.weforum.org/pdf/globalrisk/globalrisks2010.pdf was presented at a risk and insurance conference during the last week of April. (*A Global View of Risk*, O'Sullivan, CFO Magazine, April 29, 2010).

The report ties in to a theme in our April 8, 2010 Digest. In that Digest, we discussed the new US proxy rules with respect to disclosure of board risk oversight. Specifically, we discussed the fact that many boards, in the proxy discussion of their risk oversight role, had a noticeable gap: they had not been disclosing the way they oversee *the risks of their own performance and governance* practice. (See details on page 4 at http://www.thevaluealliance.com/PDF/CGADigest040810.pdf)

If you haven't made these disclosures or considered the board's role of self-oversight, based on the fifth annual Global Risks Report of the World Economic Forum, there is every reason that you should.

According to the Global Risks Report, "*Global **governance gaps*** … are the **most significant source of risk in terms of interconnectedness**… experts have identified **weak or inadequate institutions or agreements in almost all of the risks covered** … [this] **reinforces the message** of the *Global Risks 2009* report of **how crucial it is to focus on global governance** not as an end in itself but **as a means to address many critical global risks** over the coming years." (Global Risks 2010, World Economic Forum, page 8, bold added)

Too often, directors, managers and investors have a too narrow view of what "governance" is and the impacts of choices in governance. (The Governance Chapter: Investor Relations Guide, Bloxham, May 2005, Kennedy Publications)

The Global Risks Report, in Figure 2 **shows "global governance gaps" at the very center of risks** ranging from air pollution to fiscal crises, food price volatility and asset price collapse, to chronic diseases and transnational crime and corruption. Figure 14 of the report reinforces this as well. (Global Risks 2010, World Economic Forum, page 9)

The report states that there is a "**marked increase in interconnectedness among the risks** covered "(i.e. risk interdependency), with **governance at the center** of many of them. (Global Risks 2010, World Economic Forum, page 9)

Clearly, while **corporate directors** don't represent the sum total of governance, their oversight (or lack thereof) **can collectively have tremendous impacts on global prosperity and global risks**.

The report addresses three major themes:
(1) "The **increase in interconnections among risks** means a **higher level of systemic risk** than ever before"

(2) "The **biggest risks facing the world today may be from slow failures or creeping risks**"

(3) With respect to **global governance gaps**: "The next years will test the political will, vision and willingness of governments, business and individuals alike **to make tough choices and manage the challenges ahead**." The report pleads: "Can the necessary **reform of global governance be achieved across the range of issues** where it is required?" (Global Risks 2010, World Economic Forum, page 5)

Understanding where your business fits strategically within the risks facing the

globe, whether they be economic, geopolitical, environmental, social or technological, can make your strategic discussions more valuable. (Nanoparticle toxicity is one of the three named technological risks in the World Economic Forum report, by the way – for more information on this topic, see page 1 in the March 9, 2010 Digest http://www.thevaluealliance.com/PDF/CGADigest030910.pdf.)

Questions for Boards to answer include:

- What are the major uncertainties, problems and issues the world needs to solve?
- Where does our company fit in terms of solving (or exacerbating) the world's pressing problems?
- Have we articulated to stakeholders where we fit in providing solutions?

Whether your company is solving (or exacerbating) the world's pressing problems will speak volumes to the long term sustainability (or not) of your business model. While management may be looking five, perhaps ten years out, directors have a responsibility to have a longer term view.

In our April 8, 2010 Digest, we discussed the fact that around 85% of financial executives believe the risk reports they provide to the Board are less than excellent. (You can find other statistics in more depth here. http://www.thevaluealliance.com/PDF/CGADigest040810.pdf pages 1 and 2.)

There is a definite point of view in the choice of risks listed as risks in the World Economic Forum's Global Risks Report; for example, although the important risk of *unemployment* is discussed in some length as well as the risk associated with *population growth*, both of these critical risks are not listed as risks per se on the diagrams.

For that reason and just healthy skepticism, the major risks outlined in the report shouldn't be accepted as is. Nevertheless, developing one's own list, with some prodding from reports like this -- and paying heed to major global risks, can help set a **focus for the board's risk and strategy discussions and pull the discussion of governance to the center core** where it belongs, as the report suggests.

As an example, to really engage in blue sky thinking, a board might wish to stand back and explore: how does our governance and decision making around energy impact the severity and likelihood of certain geopolitical risks? And so on.

Strategy and Reputation Risk: Consumers, Investors, New Media, New World

"Opponents of Arizona's new anti-immigrant law are calling for a boycott of the state's products - including the popular Arizona Iced Tea. The problem: Arizona Iced Tea is actually brewed in New York." (*Opponents of immigration law call for boycott of Arizona Iced Tea - but it is brewed in New York!*, Kennedy, New York Daily News, April 28) "Actual Arizona firms that face a boycott: Cold Stone Creamery, Dial soap, PF Chang's, Fender guitars, U-Haul, Go Daddy, Sky Mall, US Airways and Best Western. San Francisco has banned official city travel to Arizona." (*AriZona Iced Tea brewed in New York, actual Arizona firms include Cold Stone Creamery and U-Haul,* Kennedy, New York Daily News, April 28)

Much of the activity surrounding this boycott has occurred on Twitter.

Of course, choice defines our current marketplaces. Products are available from every corner of the globe – in every color, shape and size. (Financial products are also teeming in abundance.)

With the dizzying array of choice, we have created what is commonly referred to as a "consumer culture" with consumerism an expression of meaning to more and more people around the globe. Similarly, there is a dizzying array of choice in investment instruments, as showcased recently in the conversations around financial "innovations". Investing is becoming more multi-dimensional with a growing number of mainstream investors beginning to express themselves with environmental, social and governance concerns.

Is this noise or something worthy of focus? It is worthy of attention.

While the major trend post-crisis has been to reflect on the impact of corporations on society, this is a conversation, and society, with the aid of social media (which includes mainstream press now online with commentary from readers), will have a growing influence on the shape of all corporations over time, in a way that will be increasingly proactive rather than reactive.

"The extended social conversations that social media allow are reshaping awareness about companies and impacting the future of broader social causes. Whether social media benefits a company or not depends on what the company stands for, not simply what it says or the actions it takes (positively or negatively in a narrowly defined way)." (*Behind the Boardroom Door with Eleanor Bloxham, SOCIAL Media and SOCIAL Purpose: A Boardroom Issue*, Bloxham, IR Update, March 2010)

A **strategic issue for boards to stand back and consider**, indeed.

Research News: Decision-making Risk and Strategic Location, location, location

Does luxury promote better decision-making – for CEOs on company jets or boards on strategic retreats, for example? A recent study seems to have an answer – and counterintuitive as it may seem, **surrounding oneself in luxury has decided negative impacts on decision-making**, that is, if, as a board or senior management team, your focus is on service to others rather than yourself.

It turns out, without individuals even being aware of it, new research "demonstrates that **mere exposure to luxury goods increases individuals' propensity to prioritize self-interests over others' interests**, influencing the decisions they make". (Quote from a working paper entitled *The Devil Wears Prada? Effects of Exposure to Luxury Goods on Cognition and Decision Making*, Roy Y.J. Chua and Xi Zou, HBS Working Paper 10-034 http://www hbs.edu/research/pdf/10-034.pdf, featured in *The 'Luxury Prime':*

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How Luxury Changes People, Sarah Jane Gilbert, Harvard Business Working Knowledge, February 1, 2010)

Since boards are the guardians of the company's long term assets, including its reputation and long-term relationships with stakeholders, directors need to monitor the CEO's and their own relationship to luxury and its impacts on decision making.

Anecdotally, we have all witnessed that the propensity for luxury (e.g. newly decorated offices, expensive trash cans) has been an issue in many cases of CEO downfall. The authors of the study conclude: "Will the same business meeting reach different decisions when it is held at a luxury resort as opposed to a modest conference room? Will CEOs who bequeath themselves expensive office facilities and luxurious corporate jets make different business decisions than those who do not? In this age of Wall-Street excesses, these are pertinent questions that could further our understanding on why some actors continue to place their own interests over others', even in difficult economic times."

Since social awareness is more important than ever, consciously exposing oneself to environments that dull that sense and the ability to see through others' eyes, would seem to be irresponsible – and perhaps very harmful to the firm as a whole and the people in it. Rather, **boards should encourage CEOs and senior management teams to step out of the cocoon of luxury they inhabit** as a better choice and a step in the right direction. (See also the March 9, 2010 Digest on management practices ala the Undercover Boss, http://www.thevaluealliance.com/PDF/CGADigest030910.pdf, pages 1 and 2)

Research News: Pay for Performance or Pay for Looks?

"After adjustment for various factors including the size of their company and their experience", it turns out that **"mature-looking and less baby-face-looking" CEOs "got 7.5% more pay" although "there was no evidence that" they "performed any better"** according to a "new study, [by] Fuqua School of Business finance professors John R. Graham, Campbell R. Harvey and Manju Puri." (*Good Looking CEOS Get Paid More, Study Finds*, David Randall, Forbes, April 28, 2010)

Clearly, this study would indicate that a more objective appraisal, from a distance**, might produce a less skewed result.**

Research News: Markets Value Stocks based on Regulatory Regimes

Regulatory regimes matter.

In an article to be published this month on evolving changes in the capital markets and their importance for boards, I cite a study in the emerging markets. "A study undertaken by Pace University and Alliance Bernstein has shown that 'the stance on corporate governance and equity culture and the political, social, and environmental climate of the country are both positively and significantly related to firm-level governance' and 'firms located in countries with high country-level governance ratings did in fact predict significantly better future risk-adjusted stock return performance'. Thus, **regulations which ensure high standards of governance, in a country, seem to be positively correlated with better market valuations and better returns, a rising tide lifting all boats**." (*Behind the Boardroom Door with Eleanor Bloxham, Trading and Market Structure Trends: Issues for Boards*, Bloxham, IR Update, May 2010 citing the study *Corporate Governance Ratings in Emerging Markets: Implications for Market Valuation, Internal Firm-Performance, Dividend Payouts and Policy,* Aron Gottesman, Matthew Morey, Edward Baker, Ben Godridge, April 6, 2007)

Just released research also supports **the importance of regulatory regimes to stock price**. "On March 21, 2007 the SEC instituted Rule 12h-6, which makes deregistration much easier. Although the rule includes various complications, it basically asserts that, if U.S. trading interest is less than five percent, the firm can deregister and stop complying with the SEC reporting requirements." Research shows that: "for firms located in countries with the weakest disclosure and investor protections, the market reacted negatively to their ability to easily terminate U.S. registration. However, for firms located in countries with strong investor protections, the market did not view the option of easier deregistration as a negative event (137)". The researchers "conclude that **disclosure and corporate governance implications of U.S. registration are valued by investors**". (From the Spring 2010 Risk Management Research Report http://www rmrr.com/ citing *Escape from New York: The Market Impact of Loosening Disclosure Requirements,* Nuno Fernandes, Ugur Lel, and Darius P. Miller, Journal of Financial Economics*,* 2010, 95, 129-147.)

Again, this demonstrates the **"competitive advantage" of stricter regulatory regimes** and the ability of those stricter regimes to promote **advantages in market pricing for securities issuers**.

It is interesting that non-US issuers may understand these market forces better than US firms do -- as we found in a survey that we at The Value Alliance did in cooperation with Bank of New York and Broadgate Consultants in 2004. I explained the survey in a keynote at the Vail Leadership Conference this way: "In that survey of 143 ADR issuers...in other words foreign companies with shares traded here ...a full **98% believe financial transparency is important** to the performance of their stock -- and 82% believe it is 'very important'. But, in our survey of US public mid-sized companies, do you know where they ranked financial transparency? They ranked it only 5 out of 6 regulatory and governance issues and lower in importance than 'meeting market earnings per share expectations'."

Does recognition of the importance of governance and transparency present an advantage for non-US firms? Are US firms **less aware of the advantage because they are so "close"** to it?

For more on the benefits of transparency and how to handle board crises, with current case examples, please visit my new blog at www.thebloxhamvoice.com.

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