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Trust, Leadership, Creativity and Capital

by Eleanor Bloxham

(Keywords: financial reform, joblessness, innovation, complexity, trust, safety, capital markets)

US General George S. Patton: "If everyone is thinking alike, someone isn't thinking"

The end of capitalism as we knew it? "The period since early 2008 'is the worst time since I began the company,' says Charles Schwab, the father of the modern American individual investor. 'These are the most violent markets. Most people are still in a state of fear. I'd say 98 percent are still very concerned. And for a lot of good reasons. **Look at the headlines. You've got these scoundrels doing all this stuff.** People wonder, 'Who can I trust?'... **It was the end of capitalism as we knew it. The whole definition of safety and**

soundness--what does it really mean any more?" (Schwab Advisers Play Psychologist for Clients Burned Too Often, Betsy Morris, Bloomberg, May 28)

With defined contribution plans replacing defined benefit plans, retirement futures are more risky because benefits are subject to market whims. More individuals are deciding to decide where their retirement money goes. At the same time, the markets today are more risky – both the capital markets and the job markets. That means a higher cost of capital and required return on capital. It also means less capital to fund risky endeavors.

How so? If jobs are risky, can individuals afford for savings to be at risk too? *Is volatility (which includes layoffs, stock market sell-offs) the best way for the economy to create flexibility and agility?* What has happened to both the capital and job markets -- is it good for growth and innovation?

Maybe you, in your business, are insulated from the reality that Schwab describes. **But for capitalists looking beyond their nose, one question is: Who and what will fund the future?**

Maybe you shrug your shoulders, you believe money has to be put somewhere. *But why with you?* Or maybe, you don't believe Schwab's premise. Consider the following.

"Money has flowed out of equity mutual funds and into bond funds for seven straight weeks, the Investment Company Institute said in its latest report on fund flows. Stock funds suffered a net outflow of \$1.8 billion in the week ended June 16, the ICI said Wednesday. That brings their total outflow since the market turned at the end of April to \$35 billion." (Stock funds shrivel for seventh

straight week, Colin Barr, Fortune CNN Money, June 24)

The Chicago Booth Kellogg School Financial Trust Index shows the **percentage of people in the US that trust the stock market: 16%; that trust large corporations: 13%**. Banks are at 34% and mutual funds at 30%. (<http://www.financialtrustindex.org/resultswave6.htm> and also discussed in *Merrill's creepy new online brokerage*, Colin Barr, Fortune CNN Money, June 17)

Is this fair? Is your firm penalized by the actions of others?

Think of it this way: did you ever get in trouble for what your sibling did? What was your strategy – or would have been your best, most honorable strategy? Stand out as "extra" good and encourage your sibling to behave?

The lack of trust is reflected in a WSJ/NBC News poll (*Confidence Waning in Obama, U.S. Outlook*, Peter Wallsten and Eliza Gray, WSJ, June 23):

- Majorities favor **more regulation of Wall Street firms, health insurers and "big corporations."**
- A majority favor greater offshore drilling, while at the same time nearly 2/3 want more regulation of oil companies and support legislation to reduce carbon emissions and increase the use of alternative and renewable energy sources, even if it means an increase in energy costs

Maybe Schwab is wrong – it isn't the end of capitalism as we knew it?

But how to restore trust more broadly – do regulators and prosecutors provide the solution?

The US financial reform bill is now out of conference. It excludes a requirement for majority voting of directors, requires say on pay every three years (versus annually) and says the SEC can decide on proxy access (which they were slated to do in any case). Here's a link to conference report coming out of the US House and Senate.

http://www.thevaluealliance.com/PDF/financial_regulatory_reform_final.pdf

“Congressional lawmakers changed financial regulatory overhaul legislation this week in a way that **favours Delaware's corporate interests**, easing more than a year's worth of worries for state officials. Those officials had feared that proposed corporate governance reforms at the federal level would undermine Delaware's business-friendly laws -- and the reasons corporations decide to locate in the state. Corporate franchise fees represent more than a quarter of the state's revenue -- and help keep taxes low. **‘The final bill now contains no significant mandates in the area of corporate governance,’** said Delaware Secretary of State Jeffrey Bullock. ‘That's good news for Delaware.’ (*Less intrusive regulations allow Delaware officials to exhale*, Nicole Gaudiano, Delawareonline, June 26)

“The financial crisis ... destroyed iconic American companies... [cost] tens of thousands of workers their jobs...[and] pushed millions out of their homes. And that's just in the U.S.-- forget the fallout still raining down on Europe and the rest of the globe. So where are the jail terms, or at least the perp walks, for those who oversaw it all?” ... What about the financial shenanigans ala Repo 105 at Lehmann? ... “Already populist anger on Main Street is boiling over, and no wonder. As long as prosecutors continue to look at such white-collar crime as too difficult or too unrewarding to tackle, **you can expect the mercury to just keep rising.**” (*Why no jail time for Wall Street*, Becky Quick, Fortune CNN Money, June 23)

Frauds have **shaken the confidence in the country's regulatory system** says attorney Bowman Brown. Randy Shain argues: “the public might very well be better off with no top financial regulator

at all ... the SEC, if it is to exist, should be bold.” (*Fix the SEC, or abolish it!*, Randy Shain, Fortune CNN Money, June 23)

Is it possible to win the battle and lose the war?

So what is the pragmatic way forward if you believe (or even if you don't believe) we are in a new era of capitalism? As in any endeavor, it's the fundamentals -- innovated and contextualized to our times.

Use the capital you have wisely. How?

Better mechanisms to allocate the capital you have now. Many companies don't incorporate risk costs in their capital allocation decision making but they should as it would change what they chose to invest in. (There are risk costs to *lack of innovation* too.) As a director you should ask management to provide this information to you.

Another tool to preserve capital is to *monitor projects and reward executives on the same basis used to approve them* -- including risk costs of course. (Many companies use one basis to approve and then reward based on earnings or an accounting derivative.) If management isn't doing this and not providing this information to you, you may want to ask that they do because without it your enterprise risk systems are merely traffic lights on a page rather than a living, breathing part of the way the managers manage the business.

(My book in the [Wiley Finance Series](#) discusses these issues in depth or if you want more information on these topics, just email me ebloxham@thevaluealliance.com.)

Improve your reputation by improving the way you do business -- and encourage others in your industry to do the same. How?

For financial institutions improve your governance. “Compiled for *American Banker* by the Reputation Institute... an online poll of nearly 7,800 consumers in January and February ... shows that **governance, or how a company**

behaves with respect to ethics and transparency in its business dealings, is the most influential factor in a bank's reputation, accounting for 15.9% of the overall score, edging out products and services, at 15.7%.” (*Bank Reputation Rankings Flash Red*, Heather Landy, American Banker, May 17)

In broader corporate America, a company's products and services are the biggest drivers of reputation, accounting for more than 18% of the score... based on the Reputation Institute's annual survey of 150 large companies across a variety of industries. (Bank Reputation Rankings Flash Red, Heather Landy, American Banker, May 17)

Across the globe: If you want to build a positive global reputation? “Reputation Institute conducted a survey to assess the strength of the world's 600 largest companies (by revenue) in their home countries. Then consumers in 24 countries judged the 54 highest-rated companies, giving them more than 181,000 reputation ratings--from 0 to 100--on their products and services, innovation, workplace, governance, citizenship, financial performance and leadership.” What mattered? Innovation, commitment to citizenship and transparency. Google ranked first and Sony second. (*World's Most Reputable Companies*, Laurie Burkitt, Forbes, May 24)

Country reputations: The perception of countries related to respect, trust, admiration, esteem and good feelings can have impacts too and it's important to know when your thinking may be skewed, differing from the opinions of the rest of the world.

“Japan is the only place where non-residents think more of the country than its residents.” While others view China at 38 and Russia at 36 (compared, for example, to Switzerland at around double that amount i.e. 73), both country's own residents perceive their country *more than twice* as well as others do -- China's residents rank it 41 points higher and Russia's 38 higher than outsiders. India and the US are ranked comparably by others at 50 and 48 respectively, but those figures are 32

points (India) and 29 points (US) lower than its own residents. (*How Countries See Themselves*, Simon Briscoe, FT.com Magazine, Jan 16/17, Source: Reputation Institute, 2009)

Innovate. How?

“The fact is, the days when innovation was focused primarily on technological breakthroughs and new product development are gone. Fast-paced environmental shifts require constant change ... Organizational flexibility and agility are now critical capabilities for any corporation trying to lead.” (*Innovation's Dirty Little Secret*, Jeneanne Rae, Bloomberg Business Week, June 21)

“Design and innovation are as important in the strategies and tactics of the boardroom and the executive suite as in the engineering and design divisions.” Take this scenario: “The current technology is still generating solid revenue—but since the growth is trailing off, the executive is hypersensitive about maximizing the revenue stream. So, the answer in regard to making a product from the new technology is a solid ‘No!’ The ambitious, smart young team that developed the new concept leaves the company and joins a startup.” “The better we do, the bigger the problem we make... the real enemy is great design. Why? Because great design takes hold, gets traction, and takes on its own inertia—which makes it hard to replace. And replace it we must: Everything reaches its past-due date.” (*The Problem with Great Ideas*, Bill Buxton, Bloomberg Business Week, June 9)

Innovation goes beyond products to the way that business is done and it reaches beyond great design. More and more consumers care about “invisible features”.

“Smartphones, laptops and digital cameras — are built from minerals that seem to be fueling mass slaughter and rape in Congo.” “Partly as a result, requirements that companies report on their use of conflict minerals were accepted as an amendment to financial reform legislation.” (See section 1502 in the conference report —

http://www.thevaluealliance.com/PDF/financial_regulatory_reform_final.pdf.

“Protesters demonstrated outside the grand opening of Apple’s new store in Washington, demanding that the company commit to using only clean minerals.”

<http://www.youtube.com/enoughproject> (*Death by Gadget*, Nicholas D. Kristof, NY Times, June 26)

“San Francisco just became the first city in the country to pass legislation making cellphone retailers display radiation levels... Different phone models emit anywhere from 0.2 watts per kilogram of body tissue to 1.6 watts, the legal limit. The amount of radio frequency energy seeping into the body and brain is measured by a unit called the Specific Absorption Rate (SAR).” (*Are Cells the New Cigarettes?*, Maureen Dowd, NY Times, June 25)

Innovation and governance, working together, means listening to ideas up and down the line and across it that suggest taking another direction or using a better path. “Since the onset of the oil spill in the Gulf of Mexico, some of the smartest scientists and engineers have donated their clean-up ideas to BP and the oil company has snubbed them, even though most of BP’s own attempts have failed miserably. Case in point is Innocentive, a firm employed to help define problems for large companies and post the problems as challenges for entrepreneurs to solve. Usually, the problem solvers receive cash awards, with corporate clients footing the bill. But on May 4, the firm issued its first pro-bono challenge, asking for solutions to the oil spill, with plans to send the best ideas to BP (such as ‘Hypalon containment’ from Canadian scientist Ed Melarek)” But the relationship has become mired down in red tape. (*BP Snubs Innovators*, Carmen Nobel, TheStreet.com, June 25) This isn’t just a BP issue. It is the quintessential issue all too familiar to many intra and entrepreneurs in countries with large companies: innovation squashed. (With respect to BP, also see my article on ways boards can think about creating cultures that listen and adapt http://money.cnn.com/2010/06/22/news/companies/bp_horizon_macondo_whistleblower.fortune/index.htm)

In a survey completed in January by IBM of over 1,500 CEOs worldwide, nearly 80% (79%) anticipate greater complexity ahead. “Asked to prioritize the three most important leadership qualities in the new economic environment”, creativity was cited most often (60%) and integrity second (52%). All other attributes were chosen by 35% or fewer. (Humility and fairness tied for last at 12% each, in contravention to the wisdom and principles in Jim Collins’ work.) (*Capitalizing on Complexity*, IBM)

Inevitably, creativity and integrity are linked. Employees will be unable to create effectively in an unethical environment – or one that lacks integrity. In fact, the preconditions to creativity are very important to creating that leadership quality. For integrity, business practices matter. Another human precondition is a sense of safety. Again, business practices matter here. (*Economic Value Management: Applications and Techniques*, Bloxham, 2002, John Wiley and Sons, p. 32)

A question for the board to consider is whether the company has examined the ways it can create greater integrity both in the narrow sense and in the larger sense of wholeness. (Our way of making a decision is consistent with how we monitor and reward is just one example.) Is that wholeness transparent?

The importance of a *sense of safety* to creativity and innovation, of course, brings us back to where we began. Safety (or its absence) in the lives of people (as employees, customers, capital providers) impacts their creativity and their own and a corporation’s ability to innovate and grow.

Research is demonstrating this and is worthy of review. (See *Creativity and innovation in organizational teams*, Leigh L. Thompson, Hoon-Seok Choi, Lawrence Erlbaum Associates, 2006, p. 109) It has long been accepted that children need safety to learn and grow. Recent brain research has shown the ability of four year olds to best adults in creatively discovering how something really works -- as adults seem to erroneously “rely more on their prior knowledge that *things do not work that way*”. The researchers point out that

“Across the animal kingdom, the **intelligence and flexibility** of adults are correlated with the immaturity of babies.” Crows can figure out how to fashion tools but young crows depend on their parents much longer than chickens. The brains of babies seem to be wired for “prodigious feats of learning and creativity.” They are “more flexible than adult brains” and “have more connections between neurons”. (*How Babies Think*, Alison Gopnik, Scientific American, July)

To solve and best the complexities of our world, the challenge is to understand how to reconstruct our educational systems and work environments to create *safe environments* for young adults and older adults, to think creatively and discover new ways to provide adults *time and space* in the right environment to be able to make more neuron connections and think exploratively, flexibly and creatively. Perhaps it is Google’s ability to do just that that is behind its Number One spot on worldwide reputation.

For more in-depth analysis of these and other topics, visit and subscribe to my new blog, The Bloxham Voice, www.thebloxhamvoice.com