THE CORPORATE GOVERNANCE ALLIANCE DIGEST

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July 2010, the Month of New Investor Responsibility

Keywords: investor, FRC Stewardship Code, Financial Reform Bill, Schwab, Merrill, tax havens, compensation, proxy access, governance, whistleblower

The more we know, the less certain we become.

If you are a bank director, please join me in Charleston in September where I'll be discussing bank *enterprise risk management* and *board evaluations* – for banks. http://www.thevaluealliance.com/PDF/swgsb_assembly_bank_directors.pdf

The Investor 3 Rs of 2010: Risk ?, Returns ?, More Responsibility √

by Eleanor Bloxham

Two major events this month, the running of the Bulls in Pamplona and the McCleary Bear Festival in Washington State… no, no that's not right – Two major events this month, the enactment of the UK Stewardship Code and the US Financial Reform Bill put more **responsibility squarely on the shoulders of investors to monitor corporate oversight – and themselves**. *How well will they do?*

In this digest:

I. Investor Report Cards are Coming
II. The UK Corporate Governance and Stewardship Codes: Key Takeaways
III. The US Financial Reform Bill: Good Governance Makes the Medicine Go Down

I. Investor Report Cards are Coming

With the advent of more responsibility, how well have investors done with their current responsibilities? Unfortunately today, there aren't a lot of report cards (other than the financial hits investors have taken or returns they have achieved) we can use to measure their effectiveness.

One report card from research by Greenwich Associates: "Some 30% of Asian institutions say the performance of external managers during the financial crisis has prompted them to alter their long-term plans in favour of more internal management, compared to 3% who plan to move in the opposite direction... Almost 2/3 of Asian institutions say they will 'significantly' strengthen their internal expertise and capabilities in the next 12 months." "80% ... of institutional assets in the US are allocated to external investors... while in continental Europe there is a near 50-50 split." "Just 12% ... of assets held by Asian institutions is available to external managers, underlining a key reason why western fund managers have struggled to break into a potentially lucrative market." (*Asia keeps assets closer to home*, Steve Johnson, Financial Times, July 4)

One US voting report card of votes by 25 mutual fund families was issued July 20. The report was the combined effort of AFSCME, The Corporate Library, ProxyDemocracy, and Shareowners.org. The data showed the fund families that tended to vote for or against 41 named directors, where excessive pay was indicated as the issue at stake, at 17 companies. TIAA-CREF was at the median, supporting those directors about ½ the time. "Six fund families — Vanguard, RiverSource, Northern, Invesco, Federated and Columbia — supported all of the directors on whose election they voted; Evergreen, Fifth Third, Legg Mason, MFS, Schwab and T. Rowe Price voted for none of them."

The scarcity of report cards for investors is getting ready to change – with the enactment of the new UK Code and the US Bill.

II. The UK Corporate Governance and Stewardship Codes: Key Takeaways

Sometimes (often, lately) the winds move from the UK to the US (and elsewhere) on corporate governance matters. They have had a history of proxy access and say on pay. If the trend continues, what responsibilities can investors expect?

II.A. The UK Corporate Governance Code, issued in June, includes calls for annual elections of directors and includes colorful language: "Chairmen are encouraged to report personally in their annual statements…the personal reporting on governance by chairmen, as the leaders of boards, might be a turning point in attacking the fungus of 'boiler-plate' which is so often the preferred and easy option in sensitive areas but which is dead communication.”

Following the financial reform bill and this year’s proxy season, there are many more discussions in the US about the adequacy of communications. Of course, it can be helpful if investors and others speak up so that you know what’s working and what isn’t.

The Main Principles (summarized on pages 6 and 7 of the code) consist of 5 categories: leadership, effectiveness, accountability remuneration, and relations with shareholders. Following are selected excerpts that may be of particular interest:

Insurance. “The company should arrange appropriate insurance cover in respect of legal action against its directors.”

Chairman and CEO. “A chief executive should not go on to be chairman of the same company. If, exceptionally, a board decides that a chief executive should become chairman, the board should consult major shareholders in advance and should set out its reasons to shareholders at the time of the appointment and in the next annual report.” The Chairman and CEO should not be the same person as “The chairman is responsible for leadership of the board and ensuring its effectiveness on all aspects of its role.” (Note: shareholders assume some responsibility here.)

Role in strategy. “Non-executive directors should constructively challenge and help develop proposals on strategy.” (That’s more proactive than many directors might view their role. Would shareholders welcome this?)

Minutes and resignation practices. “Where directors have concerns, which cannot be resolved, about the running of the company or a proposed action, they should ensure that their concerns are recorded in the board minutes. On resignation, a nonexecutive director should provide a written statement to the chairman, for circulation to the board, if they have any such concerns.” (In litigation, this practice can help show that the board doesn’t rubber stamp – that there is discussion and reasonable disagreement.)

Diversity/gender. “The search for board candidates should be conducted, and appointments made, on merit, against objective criteria and with due regard for the benefits of diversity on the board, including gender.” (Merit is important -- and a board that seeks out those who look different from them. Some investors already look at this.)

Term limits. ”Non-executive directors should be appointed for specified terms subject to re-election and to statutory provisions relating to the removal of a director. Any term beyond six years for a non-executive director should be subject to particularly rigorous review, and should take into account the need for progressive refreshing of the board.” (Six years is an interesting cut-off; the faster the pace of change, the more this can make sense.)

Time of Chairman. “For the appointment of a chairman, the nomination committee should prepare a job specification, including an assessment of the time commitment expected, recognising the need for availability in the event of crises.” (Note to US boards with lead directors: consider the time commitments for lead directors – some are, unfortunately, “overcommitted”, a negative sign to investors.)

Terms and conditions. “The terms and conditions of appointment of non-executive directors should be made available for inspection. The letter of appointment should set out the expected time commitment.”

Board education. “The chairman should ensure that new directors receive a full, formal and tailored induction on joining the board. As part of this, directors should avail themselves of opportunities to meet major shareholders.”… “The chairman should regularly review and agree with each director their training and development needs.” (On some US boards this might be the lead director’s job. Again, a role for shareholders is outlined.)

Board evaluations. “The chairman should act on the results of the performance evaluation by recognising the strengths and addressing the weaknesses of the board and, where appropriate, proposing new members be appointed to the board or seeking the resignation of directors.
Individual evaluation should aim to show whether each director continues to contribute effectively and to demonstrate commitment to the role (including commitment of time for board and committee meetings and any other duties). The board should state in the annual report how performance evaluation of the board, its committees and its individual directors has been conducted. Evaluation of the board of FTSE 350 companies should be externally facilitated at least every three years. A statement should be made available of whether an external facilitator has any other connection with the company. The non-executive directors, led by the senior independent director, should be responsible for performance evaluation of the chairman, taking into account the views of executive directors.” (On some US boards the word chairman should be replaced with lead independent director in the above description. Discussing the evaluation is a beneficial practice as the digests have noted this year, one shareholders will welcome.)

Auditor oversight. “The annual report should explain to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded.” (More broadly explaining in a coherent way major decisions such as these can help build trust with investors.)

As an aside, “Auditors fell short of regulators’ and society’s expectations in the run-up to the banking crisis by showing a ‘worrying lack of scepticism’ in some of their audits of financial institutions, the Financial Services Authority said. A discussion paper it issued on Tuesday – the most strongly worded official criticism yet of the audit profession’s role in the crisis – raises the prospect of increased enforcement against auditors, especially the Big Four.” (*Auditors under fire for role in bank crisis*, Rachel Sanderson and Brooke Masters, Financial Times, June 29) “FSA identifies that firms have taken particularly aggressive approaches to fair values or impairment, and the auditors do not seem to have been sufficiently robust in their challenge," the report notes.

An example of auditor failures they may be concerned about? "Citigroup agreed to pay $75 million to settle with SEC charges that it failed to disclose $40 billion in subprime exposure to investors in 2007." (*The SEC's Citi Complaint: When $13 Billion Should Have Been $50 Billion*, Stephen Grocer, Wall Street Journal, July 29)

What about internal audit – where are they? A new book on internal and IT audits discusses practices to consider: **"SWANSON on Internal Auditing: Raising the Bar"** See http://www.itgovernanceusa.com/product/250.aspx and http://www.itgovernance.co.uk/products/3109

II.B. The July 2010 Financial Reporting Council (FRC) UK Stewardship Code Following on the heels of its new UK governance code issued in June, the FRC issued a code for **investors** to provide **guidance on good practices** they should adopt**.** One way to judge investors, going forward, is whether or not they follow the good practices outlined in the new Stewardship Code.

This is serious business: "As with the UK Corporate Governance Code, the Code should be applied on a 'comply or explain' basis. In reporting terms, this entails providing a statement on the institution's website that contains: a description of how the principles of the Code have been applied, and disclosure of the specific information listed under Principles 1, 5, 6 and 7; or an explanation if these elements of the Code have not been complied with."

The summary of the principles states that "Institutional investors should **publicly disclose** their policy on how they will discharge their stewardship responsibilities, have a robust policy on **managing conflicts** of interest in relation to stewardship and this policy should be publicly disclosed, **monitor their investee companies**, establish clear guidelines on when and how they will **escalate their activities** as a method of protecting and enhancing shareholder value, be willing to **act collectively** with other investors where appropriate, have a clear policy on **voting** and disclosure of voting activity, [and] **report** periodically on their stewardship and voting activities."

Here are highlights of some of these: **Monitoring**. "As part of this monitoring, institutional investors should: seek to satisfy themselves, to the extent possible, that the investee company's board and committee structures are effective, and that independent directors provide adequate oversight, including by meeting the chairman and, where appropriate, other board members." (Are investors knowledgeable?)

Escalate. "Instances when institutional investors may want to intervene include when they have concerns about the company's strategy and performance, its governance or its approach to the risks arising from social and environmental matters." (Do investors know how to approach this in an effective manner? Do they understand good governance principles?)

Voting. "Institutional investors … should not automatically support the board. If they have been unable to reach a satisfactory outcome through active dialogue then they should register an abstention or vote against the resolution. In both instances, it is good practice to inform the company in advance of their intention and the reasons why." (Are investors knowledgeable and not simply proxy voting guidance followers?)

Report. Reporting includes "qualitative as well as quantitative information" and "how votes have been cast." "Those that sign up to this Code should consider obtaining an independent audit opinion on their engagement and voting processes … The existence of such assurance certification should be publicly disclosed." (Do investors implement the kinds of continuous improvement processes they advocate for the companies they invest in?)

In follow-up to this Code and other developments, investors are on the hot seat now.

"The UK government is considering creating a single 'powerful' new corporate governance regulator which would supervise corporate governance, company disclosure and institutional shareholders' stewardship of companies … there is a concern amongst investment managers that there should not be unrealistic expectations about what they can achieve through engagement – although managers do generally recognise that the engagement process needs to change and improve." (*UK considers single powerful corporate governance watchdog*, Daniel Brooksbank**,** Responsible Investor, July 26)

III. The US Financial Reform Bill: Good Governance Makes the Medicine Go Down The US Financial Reform Bill places more responsibility on the investor which boards will need to manage.

III.A. Non-bank/financial institution directors on well governed boards will be miles ahead of their peers in terms of educating investors and communicating with them, the major areas of impact for non-financial services boards. As always, the best way to prevent having to react to new legislation is to be a proactive board that follows great practices all along and takes care of its health by getting regular checkups by an independent third party.

Proactive Defense I - against **proxy access**: *Good shareholder relations, governance, compensation, strategy and risk processes and solid nominations and board refreshment practices well articulated.*

Proactive Defense II - against **compensation provisions** including say on pay, pay versus performance and pay equity disclosures, new requirements on compensation committee and consultant independence, golden parachutes, claw backs and hedging policies in the new bill: *Good shareholder relations and solidly defensible compensation practices, articulated well and coherently, that take into account risk and other special issues including golden parachutes, claw backs and incentive hedging policies.*

Proactive Defense III – against **elimination of broker discretionary votes** (beyond uncontested director elections) to say-on-pay and other significant matters: *Good shareholder relations and solidly defensible compensation, governance and other esg practices*

Proactive Defense IV - against **derivatives** review requirements, disclosures of payments made to the U.S. and foreign governments relating to the **commercial development** of oil, natural gas, and minerals, disclosures related to the use of **conflict minerals**: *Strong internal controls and accounting and well functioning procedures to review these matters and flexibly implement policies and restrictions related to these and related matters.*

Proactive Defense V - against SEC **whistleblower** rewards and company requirements: *Well functioning compliance and ethics program including proactive whistleblower response and protection.*

These are the major elements in the bill for non-financial services firms as summarized in Proactive Defenses I – V above.

Related to whistleblowers, please beware: "A study published in The Journal of Management Studies [by James E. Hunton and Jacob M. Rose] has found that **…** audit committee members were less likely to follow up on a tip if it was made anonymously, even though they believed that investigating an anonymous tip was no more time-consuming or expensive to investigate than one that was made by an non anonymous source. When they did follow up on an anonymous tip, they allocated less money to investigating the issue than if it had been a non anonymous tip. The study also found that board members were less willing to treat the allegations as serious if they were serving on another board where such misdeeds were also taking place, indicating that they feared a reputation loss by missing the accounting trick at two separate companies … The study's authors conclude that a better way to protect shareholders … would be to mandate a trusted independent third party… to receive all whistle-blowing allegations." (*Big Obstacles for Anonymous Tips of Misdeeds*, Cyrus Sanati, New York Times Deal Blog, July 12)

It is very important to address these inherent conflicts and tendencies.

The need to establish regular board reviews of the ethics and compliance program are enhanced as well by the latest updates to the Federal Sentencing Guidelines effective November 1, 2010. "Recurrence of similar misconduct creates doubt" with respect to effectiveness of the program. "First, the organization should respond appropriately to the criminal conduct. The organization should take reasonable steps, as warranted under the circumstances, to remedy the harm resulting from the criminal conduct. These steps may include, where appropriate, providing restitution to identifiable victims, as well as other forms of remediation. Other reasonable steps to respond appropriately to the criminal conduct may include self-reporting and cooperation with authorities. Second, the organization should act appropriately to prevent further similar criminal conduct, including assessing the compliance and ethics program and making modifications necessary to ensure the program is effective."

Example: investors and regulators are likely to expect consequences for fraudulent financial reporting. 82% of fraud firms experience CEO turnover and 80% experience CFO turnover, 68% experience other board turnover. (*COSO: Fraudulent Financial Reporting 1998 – 2007 An Analysis of US Companies*, Mark S. Beasley, Joseph V. Carcello, Dana R. Hermanson, Terry L. Neal, May 2010)

Again, these are the major elements in the bill for non-financial services firms as summarized in Proactive Defenses I – V above. Yes, there will be technical issues to address in the new Financial Reform Bill as outlined in the July 22 Weil briefing. Detailed issues include the timing of nominations in the bylaws, the board's recommendation on how frequently to hold say on pay (every year, two years or three years), called say when on pay, ensuring golden parachute and disclosure votes at the time of M&A votes, workarounds for quorum issues for meetings (should those be required), compensation charter and procedure reviews as well as whistleblower and compliance and ethics procedure reviews, the other named reviews and potential rule changes.

As the lawyers focus on ensuring these details are carried out, it's important for board members to vigilantly keep in mind **the key strategic and governance issues** and use this as an opportunity to achieve great practice -- and avoid the trap of a too narrow compliance focus which plagued some boards during the implementation of 404 of Sarbanes-Oxley as advisors took over the conversation.

III.B. For investors, the new responsibilities for corporate oversight (including the requirements to vote and review more corporate disclosures) are ones that will require time, attention and education. The UK Stewardship Code provides a framework for thinking about some of them.

Other provisions of the bill also impact institutional investors, among them: **Disclosure of votes** on say on pay, say when on pay and golden parachutes**,** **short sale disclosures** and rules, **registration** of hedge funds and private equity advisors, greater state supervision of investment advisors, registration of municipal advisors and imposition of **fiduciary responsibility**, ability to bring **private rights** of action against ratings agencies, **curbs** on bank's investments, more issuer disclosure about underlying assets and their quality, establishment of the **Investor Advisory Committee** at the SEC, for financial institution securities holders potential changes to liquidation practices, Comptroller General study of **mutual-fund advertising**, and **divestiture** of certain assets by systemically important firms. (*Congress Overhauls Your Portfolio*, Eleanor Laise, Wall Street Journal, July 17, The US Financial Reform Bill and Official summary of bill, Weil summary)

Related to a couple of them:

Registration of hedge funds. This is part of a process to increase oversight. In related news, a soon to be released paper "found that the average company receiving a new loan from hedge funds saw a 74.8% spike in the volume of short sales during the five days preceding announcement of the new loan, as compared with the volume of short selling 60 days before the deal. By contrast, 255 similar companies turning to banks for loans saw little change in the volume of short selling during the five days prior to the announcement of new loans... While the Securities and Exchange Commission has pursued insider-trading inquiries involving hedge funds, there haven't been many high-profile cases alleging that hedge funds use inside information obtained from their lending efforts."(*Hedge-Fund Lending Draws Scrutiny* , Gregory Zuckerman, Wall Street Journal, July 3; also see *Identifying Suspicious Short Selling, But Not Who's Behind the Trades*, Karen Weise, Propublica, July 8: working draft of paper)

More issuer disclosure. This issue is now the subject of lawsuits. (*Merrill, UBS Sued by Schwab Over Mortgage-Backed Securities*, Joel Rosenblatt, Bloomberg BusinessWeek, July 14)

Overall, July is a month where investors were put on the hot seat with significant new disclosures and requirements. *As a board, what is your strategy for helping them do their job well?*

Footnote: On July 20 "**Business and Investors Against Tax Haven Abuse**" issued "a 25-page report that contends that American multinational corporations use havens to avoid $37 billion in federal taxes each year, a figure the groups call conservative." (*Small Businesses Go After Offshore Tax Havens*, Lynnley Browning, New York Times, July 19, 2010)