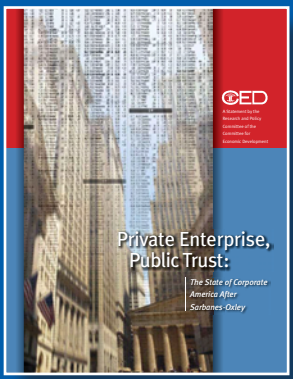

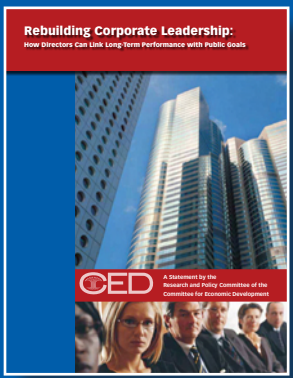

Corporate Governance Practices to Restore Trust, Focus on Long-Term Performance, and Rebuild Leadership

CED

The Best of Business Thinking
In the Nation's Interest

Corporate Governance Practices to Restore Trust, Focus on Long-Term Performance, and Rebuild Leadership*

Committee for Economic Development (CED) policy statements on corporate governance issues since 2006 have analyzed:

- How corporations could reform governance practices to regain the public's trust in the wake of corporate scandals;
- How corporate directors could promote the long-term enduring qualities of their enterprises rather than give in to financial market "short-termism;" and
- How directors could link long-term performance and public goals to improve corporate performance and rebuild their leadership position within society.

This purpose of this review is to promote discussion and debate on these critical issues. We encourage corporate leaders, government policy makers, and the interested public to join us in that discussion and volunteer their views.

Analysis

As CED began to consider corporate governance issues in 2002, the highly visible accounting scandals that surrounded the collapse of Enron, WorldCom and several other major companies—together with the revelation of fraud and other acts of malfeasance by corporate executives—aroused public outrage, called into question the values and ethics of business leaders, and undermined the public's confidence in public companies. Unfortunately, as we concluded deliberations in 2009, public outrage is again being fueled by reports of greed, conflicts of interest, and other misdeeds, and by the growing expenditure of public money to support private businesses as the government attempts to fend off a deepening recession.

The business and academic leaders who comprise CED are unwavering advocates for the free market system, and just as firm in the belief that

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** Private Enterprise, Public Trust: The State of Corporate Governance After Sarbanes-Oxley(2006); Built to Last: Focusing Corporations on Long-Term Performance (2007); and Rebuilding Corporate Leadership: How Directors Can Link Long-Term Performance with Public Goals (2009).*

businesses and their leaders must earn the public's trust. Perceptions that firms flout rules, behave unethically, and use deceptive business processes weaken confidence in, and support for, the free enterprise system. Executive compensation untethered to economic value violates perceptions of fairness, leads to mistrust, and courts a stifling regulatory backlash.

Numerous small and large corporate policies, processes, and structures—from nuts-and-bolts decision-making by line managers to higher-level strategic thinking by directors and CEOs—have resulted in the negative results we have witnessed over the last decade. CED's corporate governance reports have examined a broad range of reforms in accounting, internal controls, executive compensation, succession planning, and other board and management practices that would restore confidence and trust in American corporations and their leaders—a task made more urgent by our current economic crisis.

CED's first corporate governance report, *Private Enterprise, Public Trust: The State of Corporate Governance After Sarbanes-Oxley (2006)*, addressed governmental and corporate policies that affect the behavior of publicly traded companies, as well as the confidence of investors in them. The report acknowledged at the outset that no laws or policies will ever be sufficient to end all corporate misbehavior (or, for that matter, misbehavior in any segment of public life). It concluded, however, that truly independent and inquisitive boards of directors provide the best safeguard against corporate wrongdoing, and it recommended several ways by which corporate governance practices could be improved. It called for a new system of financial reporting that recognizes "the brittle illusion of accounting exactitude"—the misapprehension that business accounts can be measured precisely—and proposed a substantially different type of financial statement to make clear the necessary judgments behind the numbers.

A key theme embedded in these reports is that decision-making based primarily on short-term financial indicators can damage the ability of public companies—and, therefore, of the U.S. economy—to sustain superior long-term performance. Emphasis on reported quarterly earnings, compensation tied to earnings per share, shortened CEO tenures, and financial reports that fail adequately to inform about company performance impede the task of building long-term value. These phenomena are commonly known as "short-termism," and CED's recom-

mendations call on corporate boards to use their power either to eliminate these practices or to counteract their effect. In our second report, *Built to Last: Focusing Corporations on Long-Term Performance (2007)*, we call on boards of directors to address these problems by putting the long-term interests of the corporate entity at the forefront of their concerns and demonstrating through their actions that those concerns trump interest in short-term price movements.

The focus of our third report, *Rebuilding Corporate Leadership: How Directors Can Link Long-Term Performance with Public Goals (2009)*, is on the potential contributions boards of directors can make to improve corporate strategy and long-term performance by engaging responsibly with the society around them. The central conclusion of this report is that corporate boards and the leaders they select must integrate relevant societal concerns, such as environmental and human rights considerations, into corporate strategy to strengthen long-term competitiveness and the sustainability of both the corporation and the society in which it exists. A successful framework requires that societal and business leaders view and treat each others as partners, not adversaries. Their actions and public communications should recognize their interdependence and shared goals.

Many corporate leaders—directors and CEOs—have found that a principled, long-term view fosters greater appreciation of the interdependence between the corporation and the society in which it operates. These individuals are leading the development of business strategies that take account of societal challenges as a means to ensure their corporations' and society's long-term prosperity. As important, some are speaking out to urge U.S. political leaders to repair *their* broken systems so they can begin to solve long-term societal problems that hamper business as well as society's other constituents. But too few business or political leaders are following these paths.

Together, these three reports seek to restore confidence and trust in American corporations and their leaders. Public corporations are the driving force of the U.S. economy. They are the core of a system unsurpassed in creating jobs, income, and wealth, and in delivering a wide choice of goods and services. Corporate leaders should understand it is in their self interest to repair their corporate practices and to engage responsibly with the society around them.

Summary of Key Recommendations

The recommendations of CED's three corporate governance reports can be grouped as follows:

- Accountable, forward-thinking leadership
- Transparent, honest, and meaningful communications
- Long-term, sustainable performance

Accountable, forward-thinking leadership:

- The best approach to building a high-quality board is to assign to a truly independent nominating committee the responsibility for recommending new board candidates and for evaluating the performance of existing board members. The nominating committee should also have the responsibility of recommending committee assignments.

- The CEO is mainly responsible for carrying out the board's directions. When choosing a CEO, the board's selection committee should be mindful of the role that person will play in setting the tone and direction of the company with regard to ethics, integrity, and engagement with shareholders and other interested parties. The board should tie a portion of the CEO's and senior management's performance compensation to metrics based on the corporation's performance on such concerns.

- Ensure that the company has a strong succession plan and grows managerial talent internally. In the past 20 to 30 years, we have seen an evolution from CEOs who were nurtured and developed within a company, and who usually served at the will of the board without a contract, to a greater number of CEOs who are hired from outside and, for legitimate reasons, are employed by contract. Developing internal talent, in addition to providing direct benefits to the company, reduces pressure on compensation committees to offer incoming CEOs exorbitant contracts, complete with up-front signing bonuses and severance guarantees.

- The Compensation committee should adopt measurable, specific, and genuinely challenging goals (financial, strategic, operational, and social) for the performance of their business, and judge management by them.

- The compensation process must be run by a compensation committee composed of independent directors. And compensation consultants, when used, must be entirely independent of management. In selecting consultants, the committee must comprehend how the process of fixing top management compensation has broken down. Whether or not consultants are used, the compensation committee should have direct authority over all terms of any management contract, including all forms of compensation.

- Compensation committees should take care to determine whether a contract for a CEO is truly necessary. If the committee decides to use a contract, it should understand the potential consequences of all contract provisions. All contracts should have reasonable "sunset" provisions. Neither a resignation nor a notice of non-renewal for an employment agreement should automatically give rise to severance.

- Align company executives' financial interests and incentives with the long-term health of the company and its stock price. Although specific conditions should dictate a company's policies, in general top executives should be expected to purchase over time a substantial number of shares with their own money (not just from compensation awards) and to hold shares equal to an appropriate multiple of base salary. That is, executives should have a substantial equity interest in their company and should be required to act as 'buy-and-hold' investors. Vesting and exercise periods for equity grants—options or shares—should be increased beyond existing practice and tied to multi-year performance. For similar reasons, directors also should be required to buy and hold the company's shares.

- Severance compensation, like all other forms of executive compensation, should be reviewed carefully against criteria set by the compensation committee of the board, and the board should publicly provide full details of awards and explain publicly to shareholders the reasoning behind such awards.

- The company should have the right to recapture top executive bonuses if financial results by which they were justified turn out not to have been achieved when accounts are restated.

- The compensation committee should be vigilant to construct pay packages that motivate executives to maximize the company's long-

term economic value. For example, the compensation committee may want to spell out the long-term concerns they expect their CEO and other executives to address, such as employee retention, customer satisfaction, environmental sustainability, development of new products or markets, adaptability to changes in public policies, or other indicators of the company's long-term health.

- Engage major shareholders in a dialogue about executive compensation programs. Investor groups recently have begun to seek advisory votes on executive compensation, to allow shareholders to express general approval or disapproval of the company's executive compensation plan. However, an advisory vote seems a crude and unnecessary instrument for communicating about this complex topic. A simple up-or-down vote could send mixed and confusing signals. More important, we see no reason for shareholders to vote only on a company's executive compensation plan among all of the other major decisions taken by a board of directors. Because the goal of those supporting a vote is to open a dialogue about pay issues, we urge compensation committees to initiate the dialogue up front.

Transparent, honest, and meaningful communications:

- Directors should promote honesty in reporting not only on financial results and other non-financial aspects of their company's operations, but also on the risks, opportunities and results of its social interactions. Such reporting should show how the company evaluates the long-term impact of potential costs and benefits. But aside from mandated environmental and labor reporting to government regulatory agencies, corporate "sustainability" reporting should remain within the purview and at the discretion of the individual company (as it exercises its responsibility for honest and full communication with shareholders). Directors should use their authority to help the company to find a firm-specific way to communicate effectively with shareholders and the public—through the regular annual report to shareholders, in a separate public report, or in some other way.

- Audit committees must be autonomous and vigorous. In order to present a company's position accurately, the board of directors must have access to all pertinent data. This will occur only if a board's audit committee is competent, independent, and establishes effective control over both the internal auditors and the independent outside

auditors. The relationship between the audit committee of the board and the outside and internal auditors is crucial. The audit committee should exercise the same tone of control over the internal auditor as it does over the external auditor, extending to decisions of hiring, firing, and compensation.

- Financial information is inherently judgmental and financial statements would be more useful if they were governed by fewer rules and displayed more of the judgment that lies behind estimated numbers. Stock analysts, the investing public, and regulators must recognize the inherently judgmental character of accounting statements and financial information. Ranges of values rather than precise numbers should be explained and understood as such. In addition, financial statements should be supplemented with non-financial indicators of value.

- Management should make a full, timely, and transparent disclosure of its compensation to shareholders. The compensation discussion should be presented in one place in the company's disclosure and should include all forms of compensation. Disclosures should be comprehensive and easily understandable, and they should make clear how top officers would be compensated under plausible retirement or change-of-control situations.

- For their internal assessments of performance, we recommend that directors encourage management to adopt reporting systems that focus attention on "value drivers" and long-term risks, such as those proposed by the Enhanced Business Reporting framework. Directors may consider requesting reports on such metrics as part of the information provided in the board package. Companies also should voluntarily provide information derived from those systems to complement public financial reports.

- Directors regularly should consider how the company plans, manages, and communicates its interaction with society. The board should insist that management report regularly to it and to the public on non-financial performance, including social performance. To institutionalize the process, the board may want to establish a special committee or empower its governance committee to take responsibility for oversight. That committee should report to the full board and appear regularly on its agenda.

- Directors should recognize the value of corporate communication with shareholders and the public on issues that bear on the company's reputation and brand value, even when such communication may not be required by regulation or fit neatly into financial disclosure formats. Boards that have a non-executive chair or lead director may want to consider a communications role for that person on such issues and topics.

Long-term, sustainable performance:

- The board of directors has ultimate responsibility for the performance of the corporation. Directors have an obligation to act as stewards of the corporation's long-term economic health. They should widen the purview of their deliberations to give weight to societal issues that impact the firm's longer-term performance.

- Directors have a legal obligation and duty to address the long-term performance of the corporation. Directors' fiduciary duties include broader societal concerns that affirmatively affect the corporation's performance and long-term sustainability. To meet that duty, directors must consider the concerns of all—not just current shareholders, managers, or other powerful constituents—who are in a position to affect a company's long-term performance. In today's environment, boards must know that they are empowered to reject actions that produce only short-term financial results at the expense of the long-term interests of the corporation. Compensation policies, for example, should not be designed to promote purely short-term share-price enhancement.

- Acting in the shareholders' interests, the board should constructively engage with management to promote the development of long-term strategies. Such engagement should avoid the pitfall of micromanagement; rather, it should focus on the process of reviewing, appraising, and enriching management's plan, and on holding management accountable for its continuing evolution and execution. To be clear, we are not suggesting that boards usurp management functions by formulating independent strategies. Our recommendation is that directors exercise their duty to ensure that management has a long-term implementation plan for a strategy, supported by risk assessment, which enhances the enduring value of the company. After

reviewing and approving a strategy, the board should stay involved by holding management accountable for that strategy and ensuring that oversight practices are in place to assess the enterprise-wide risks to the company. Directors should measure executives' performance against strategic goals.

- Choices of forms of compensation should promote the long-term value of the firm, rather than exploit favorable accounting or tax treatment. We note that recent changes in accounting for stock options require that options be expensed on the accounting statements of public companies. The expensing of options should neutralize a bias that has favored their use in recent years. The compensation committee must also make clear the effect of its compensation decisions on stockholder dilution.

- The corporate board and the leaders it selects must integrate relevant societal concerns, such as environmental and human rights considerations, into corporate strategy to strengthen long-term competitiveness and the sustainability of both the corporation and the society in which it exists. A successful framework requires that societal and business leaders view and treat each other as partners, not adversaries. Their actions and public communications should recognize their interdependence and shared goals.

- The board should play an active role in encouraging company management to evaluate the options available and to decide explicitly what it ought to do based on sound business grounds that incorporate a longer-term view. Once a decision has been made and justified, the board should monitor implementation and continue to evaluate the company's strategy on the basis of long-term costs and long-term benefits.

- Political leaders should understand the costs they impose on business and society at large if they do not take action to improve political governance and policy making. They need seriously to address reforms in ethics, lobbying, redistricting, earmarks, and other legislative procedures and executive practices to break the logjam holding back policy reforms in substantive areas such as global climate change.

Conclusion

The conduct and performance of America's leading corporations in recent years have seriously undermined confidence in U.S. businesses and in business leaders. CED policy statements on corporate governance seek to improve the system of corporate governance and to restore public confidence in business. Putting businesses on sound economic and ethical footings and restoring public trust in business are critically important to our economy and society. U.S. business leaders should consider how their business processes can be improved, how they can improve business's ethical standing, how their business strategies can better recognize their interaction with societal issues, and how they personally can make a difference by supporting sound public policies that address society's key concerns.

CED is a non-profit, non-partisan organization of more than 200 business leaders and university presidents. Since 1942, its research and policy programs have addressed many of the nations most pressing economic and social issues, including education reform, workforce competitiveness, campaign finance, health care, and global trade and finance. CED promotes policies to produce increased productivity and living standards, greater and more equal opportunity for every citizen, and an improved quality of life for all. For more information www.ced.org.

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