

Charkham Memorial Lecture

*Directors and Boards amidst Shareholders with Conflicting Values:
The Impact of the New Capital Markets*

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I. Introduction

My Lords, Ladies and Gentlemen. It is a great pleasure to be here at the Mansion House to give this second lecture in memory of Jonathan Charkham. I had the privilege of working with Jonathan over many years, and to witness the impact of his contributions in the U.K. and abroad.

While at the Bank of England, in the 1980s, he joined me and a group of academics and business leaders on the Columbia University Institutional Investor Project. The Project was an early inquiry into the role and responsibilities of shareholders. Jonathan's papers at the Bank had criticized institutional shareholders, as he saw it, and urged more attention and engagement with companies. He was an early scholar in the field and expanded his ideas on shareholder responsibility in "*Fair Shares: The Future of Shareholder Power and Responsibility*," which he wrote with Anne Simpson. The Columbia Project concluded that companies, and wider society, needed investors to

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behave like owners. If shareholders cannot hold boards accountable, who is there? That was the common theme.

Corporate governance for Jonathan and me at the outset was company oriented. Our projects sought to awaken investors to pay attention to, and become more active regarding, the directors of the companies in which they had invested. On our side of the Atlantic, events at General Motors gave company-oriented governance enormous exposure, but basically to an audience of shareholders and boards. On your side of the Atlantic, company failures, and particularly the Maxwell scandal, gave life to the work of Sir Adrian Cadbury, Jonathan, Anne Simpson's Pensions & Investment Research Consultants (PIRC) and Mats Isaksson of the Organization of Economic Cooperation and Development (OECD). Corporate governance was not yet a national issue affecting whole economies. Rather, it was more likely to be generated by crisis, company by company.

As the years passed, corporate governance reached beyond company orientation to national and international economic orientation. Corporate governance in the broadest sense has now reached the national consciousness everywhere. Witness that in the U.S. the two Presidential candidates have expressly promised to "do something" about it.

In France, President Sarkozy may have put the task ahead most succinctly, and perhaps too softly, when he said: "We have to identify which are the effective means to channel the effects of innovative financial engineering that must serve companies, investors and savers and not be detrimental to them." In Russia, Vladimir Potanin recently noted at a conference on corporate governance that we are standing "on some kind of threshold... in front of which lies unfamiliar territory."

Today I will trace in more detail how this has evolved, but let me start with the answer to why I think corporate governance has now reached international concern.

The main reason is the advent of the capital market explosion of organizations such as hedge funds, private equity funds, state-owned enterprises, sovereign wealth funds, pension and mutual funds of all varieties, and combinations of them all. This array has created for corporations and their boards a “zoo” of owners with different stripes, teeth, sensors, claws, vision, strength, will, and attitudes. All of these must be taken into account by boards, who have always been cautioned to be “fair” to all shareholders.

Compounding the situation is the creation of a blizzard of financial instruments. Professors Goetzmann and Rouwenhorst noted in their treatise on the “*Origins of Value*” that “instruments spring from the mind of investment bankers almost overnight, and then are analyzed, valued, traded, saved, and hedged themselves—sometimes to be replaced by new financial instruments...” Today, the board of directors, sitting amidst this complex landscape combined with extensive financial engineering, must seek to steer the corporation in a coherent direction, somehow considering the values of its owners, and being responsive to those values.

How regulators may regulate, and boards may respond to, this new capital market is my subject today. It is indeed a challenge which, if Jonathan were with us, he would relish.

I suggest that, notwithstanding the magnitude of the transformations in the environment surrounding public companies, our early insights of two decades ago provide us with important lessons to deal with these novel challenges. However, now—as before—it is equally crucial to have the courage to innovate in seeking the “right” solutions to new and changing circumstances.

I will structure this lecture as follows. First, I will describe the corporate landscape of the U.S. and the U.K. in the late 1980s, and the concern about shareholder

passivity. Second, I will explain the rising role of corporate governance as a tool to address and prevent corporate underperformance and crises, as well as the deep and ongoing transformations to capital markets and the ownership structure of public corporations which took place in the last two decades. Third, I will argue that the basic insights of twenty years ago assume ever-increasing significance in today's incredibly complex corporate and capital markets environment. Finally, I will describe the challenge to formulate a new governance and regulatory regime to account for the intricacies of today's markets.

II. The Early Days of Corporate Governance: Shareholder Activism in a Simple World

In 1988, many were struck by the fact that there had been significant corporate failures of one sort or another. Management was entrenched, and boards passive if not supine. At the heart of the concern was corporate performance—or lack of it. Deficient corporate performance not only turned companies into vulnerable targets of hostile bidders willing to take advantage of depressed share prices, but also threatened the very existence of important corporations in an increasingly competitive global economy. As a result, some wondered what could be done to help shareholders find their voice and assume their proper role in the governance scheme—overcoming inertia and exerting the necessary pressure for improved performance in failing companies.

The Columbia Project concluded that companies, and wider society, needed investors to behave like true owners and take responsibility for the success of their investments. That was a beginning of what would become an important shift of focus from external solutions to the corporation itself—moving from a combination of various coercive means such as antitrust laws, mandated disclosure, taxation and criminal statutes—to an internal system of checks and balances through corporate governance practices—such as independent board composition and leadership, management and

director accountability, board-shareholder communication and corporate social responsibility.

Again, the principal concern underlying the creation of the Columbia Project was shareholder apathy in the face of corporate failures. While individual shareholders in the first part of the century could be expected to be “rationally apathetic,” the 1980s represented a period of growing consciousness that institutional investors held, in the aggregate, substantial positions in many of our largest corporations. The accumulation of economic power in the hands of institutional investors no longer supported the paradigm of “shareholder passivity.” Institutions could bring about change, if only they would act.

The main insight was that it no longer seemed sensible for these now powerful long-term shareowners to rely on regulatory action (shareholder “protection,” as opposed to “empowerment”), a “right to walk,” and hostile takeovers, as the exclusive means to protect their investment. In fact, the shares held by institutional investors were generally part of an indexing strategy, so that the “Wall Street Walk” was not readily available to them. The Columbia Project urged institutional investors to use their voices and collective power. It argued that shareholders must act like owners, and that the purpose of the corporation was to create shareholder value. By and large, with shareholders generally representing long-term institutions like pension funds and insurance companies, there was a common interest between shareholders and boards and managers. Pursuing shareholder value (even when loosely defined) would broadly ensure that companies survived, and thrived, providing returns to investors, creating jobs, paying taxes and generally serving wider societal needs.

The era of modern day corporate governance had begun. In the U.S., the institutions were badgered to find their voices and speak up by insisting on better governance, which meant implanting boards that performed their role to select the best managers available, incentivize them, monitor them, and finally remove them when they

were not performing. The notion was that the role of institutional investors in corporate governance should not be solely selling stock, or benefiting short-term from a premium generated by someone else taking over the corporation. Instead, their main contribution could be direct, creating internal forces for change—putting pressure on directors, their elected agents and fiduciaries, to improve performance.

The main target of the new demands of institutional investors was the board of directors, which shareholders properly identified as their fiduciary to deal with the prevalent unrestrained management. Passivity was not an exclusive prerogative of shareholders. Many boards were inert, beholden to the “imperial” CEO, who doubled as chairman of the board and served as the leader of a board in charge of overseeing him or herself. Strengthening the role and independence of the board became a priority for activist investors.

Various long-term shareholders, now urged to express their voice, embraced the agenda. An important theme for shareowners both in the U.S. and in the U.K. was to demand that the board of directors act as a distinct body independent from management (led by an independent chairman), monitor the performance of management (including the CEO) and guide corporate strategy, effectively taking responsibility for the company’s performance. The early promotion of independent board leadership culminated with the adoption of the Cadbury code in the U.K. in 1992 (to which Jonathan was an important contributor) and with the issuance of the General Motors corporate governance guidelines in the U.S. The existence of a strong board of directors, independent of management, was the core of the governance paradigm and the goal of shareholder activism.

Life was incredibly simple then: the targets of the early reform efforts were the large institutional investors, and they were there to see. Those institutions could be prevailed upon to perform their duty to act as fiduciaries for individuals like you and me,

the beneficiaries who in earlier times bought stock on their own. And it was far easier for boards to look out and see who their non-retail owners were—mostly the public pension funds, banks and insurance companies, and later the mutual funds.

There was also a recognition that the corporate enterprise and its institutional investors shared a common purpose. In the introductory remarks to a conference held by the Columbia Project in 1988, it is stated: “[W]e have two groups, fiduciaries and fund managers on the one hand, and corporate boards and officers on the other, with essentially mutual interests, who have made virtually no effort to obtain first-hand knowledge about each other. This predicament was the motivating force behind establishing the Project...”

Since then, these two groups have gotten to know each other a bit better than in the earlier times and to acknowledge their mutual interest in the corporation.

The then commonality of interests and purpose between institutional shareholders and the corporate enterprise was the premise on which boards and shareholders built the developing governance paradigm. But this premise of commonality seems to be eroding in the current capital markets landscape, as we shall see in a moment.

III. Corporate Governance Today

I will now sketch out for you the dramatic changes which revolutionized our then-simple premise of commonality and the governance paradigm in the short span of under twenty years, and provide a snapshot of where I think we are now. This, I hope, will make clear to you why the current historical moment has reached its watershed prominence; we are at Potanin’s “threshold” of “an unfamiliar territory.”

a) The Growth of Corporate Governance and the Legitimization of Shareholder Activism

The developments in the 1980s and early 1990s established corporate governance as a mainstream concern, which was based on the growing recognition of the importance of corporate governance to corporate performance and the development of capital markets. The corporate governance debate today is a recurrent presence in the headlines of the business press and has a place at the top of the priority list of governments and organizations seeking to encourage the development of local capital markets in emerging economies. In fact, the exponential growth of corporate governance as a movement led to the creation of a specialized and powerful advisory services industry and to the incorporation of related concepts into the political arena.

In contrast to its humble beginning as an ideal promoted by individuals and a few institutions, corporate governance today has given rise to a thriving professional industry. After shareholders were prompted to think about governance matters, it did not take long for an industry to emerge and provide advisory services for institutional investors, which are under a fiduciary duty to vote in an informed manner. Whether market driven or otherwise, this is a significant development—even though I am far from sure that the industry has provided better guidance for shareholders than the simple beginnings I described earlier (and to which I will get back later). But there it is, and it is probably too late to put the genie back in the bottle, given the fact that ISS/RiskMetrics has now gone public and has its own shareholders for whom to earn a profit out of governance advice. “Watchdogs” and commentators abound.

Moreover, what started as a voluntary private sector movement became an important item in the political arena and the object of governmental intervention. In the U.S., the corporate scandals of the late 1990s resulted in the first serious federal corporate governance mandates since the original securities laws in the 1930s, with the passage of

the Sarbanes-Oxley Act. Although the scope of federal regulation of securities markets had traditionally been limited to disclosure requirements, the importance of corporate governance was such that, in an unprecedented step, legislators built into federal legislation concepts such as enhanced board oversight and audit committee member independence. Whatever the merits of such a mandatory approach may be, the resort to legislated corporate governance practices as a regulatory tool is likely to persist.

For instance, concerns about “excessive” executive compensation have now become an important item in the U.S. political agenda. In the past, legislators dealt with the perceived problem of “runaway” executive pay through tax laws dealing with expense deductions and golden parachutes. Today, the presumptive U.S. Presidential candidates have executive compensation and the financial crises up front in campaign promises. In contrast to solutions from the past, Presidential candidates from both parties now support “say-on-pay” proposals, that is, a shareholder advisory vote on executive compensation. Dealing with politically sensitive governance issues through legislation now seems more likely than in the past.

Further, the consolidation of corporate governance conferred an aura of legitimacy to both corporate governance-related rhetoric and shareholder activism. Prior to the 1980s, activist shareholders were few, and they were at best gadflies who showed up regularly at annual meetings, but were considered no more than minor annoyances.

Efforts in the late 1980s marked the birth of shareholder activism taken seriously. These developments led the U.S. SEC to amend its proxy rules in 1992, further institutionalizing the model of shareholder voice. Again, it was an easier case—corporate governance efforts seemed the obvious (if not only) solution for shareowners holding shares for the long term. So, around the turn of the century a governance industry had developed, shareholders had become active, federal intervention had happened and strong governance practices were in place.

The shareholder/board commonality of purpose and view of shareholder value seemed to be holding as the premise on which this all had happened.

b) New Ownership Patterns and Changes in Capital Markets – The Common View Weakens

Let's turn to the changes in ownership of public corporations and the implications for corporate governance, and how the developments leading to shareholder activism are causing unintended consequences in the new capital markets. The impact of changes in ownership patterns on corporate governance is not a novel phenomenon. It was the very transformation in the ownership structure of public corporations—from the fragmentation of share ownership in the hands of powerless individual investors in the first half of the twentieth century to the progressive concentration of shares in the hands of pension funds and other institutions—that drove the initial awakening of institutional investors to corporate governance.

But, once again, ownership patterns are changing—and fast. The owners of today's corporations are not only individuals and traditional institutional shareholders such as pension funds and mutual funds. We now have an ever-changing landscape of institutional owners, which includes hedge funds, private equity funds, sovereign wealth funds, state-owned enterprises, and a host of other entities. And let's not forget how powerful these new players are. The hedge fund industry is estimated to have over \$2 trillion in assets, while Abu Dhabi, arguably the world's largest sovereign wealth fund, pumps out \$1 billion per day on average.

Significantly, each of these many types of owners has possibly different investment horizons and objectives bearing on the value they seek for the corporation.

They are not necessarily in synch. No one has ever mapped out this territory extensively. But it certainly is the veritable “zoo” of owners I mentioned.

What is more, this situation puts the model which was envisioned in the 1980s and 1990s under severe strain. At the time, institutional shareholders were presumed to share a common goal when exerting pressures on boards to monitor management and effectively guide firm strategy. That assumed homogeneity now seems dead, and the heterogeneity is ever increasing. Terms like “hedge funds,” “sovereign wealth funds,” and “private equity,” among others, have a variety of permutations, and each permutation has its own species. This diversity of shareowners has brought a whole host of agendas and values to the table.

Following discussions with OECD Secretary-General Angel Gurría at the International Corporate Governance Network (ICGN) Conference held in Korea last month, Rosemary Martin, an experienced board room participant as prior Company Secretary and General Counsel of Reuters, made powerful comments at a panel discussion, with respect to the need to deal with these conflicts in the boardroom. Rosemary noted that traditional OECD Corporate Governance Principles which say that “directors should act in the best interests of the company and the shareholders” and “where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly” become a challenge when you have a variety of owners to look after. Rosemary further warned that “[t]he challenge of having to treat all shareholders fairly—particularly when you may not know what are the requirements of every type of shareholder—can be overwhelming. The board may end up unable to act—the uncertainty can lead to inaction or a sort of sclerosis—or the board may become quite cavalier, ignoring its agency role because it is just too difficult to perform it. Neither outcome is likely to be in the best interest of the company and its shareholders.” Rosemary has added real-time reality to our belief that the board has been placed in a very new role.

There is indeed, a multitude of causes of conflict among different shareholders' interests, and the implications for board decisions will vary significantly depending on the nature of these conflicts. Take, for instance, the widely publicized conflict of investment time horizon. Pension funds worldwide depend on the long-term health of the corporations they invest in to discharge their obligations, while wealthy investors catered by hedge funds and private equity funds typically aim at realizing a significant return within a few years. (This is an over-simplification of reality, as pension funds themselves often contribute cash to hedge funds and private equity sponsors, while private equity going public adds a new group of investors to the game).

Were capital markets perfectly efficient, there should never be a short-term/long-term conflict, as the market would always reflect the value of long-term projects in the share price today. However, finance scholars have acknowledged that capital markets are not perfectly efficient, and instead suffer from a sort of myopia which unduly discounts long-term investment opportunities. As a result, a true conflict exists between short and long-term shareholders, so that favoring one investment horizon may harm the returns anticipated in the other. These conflicts can play out in many board decisions, not just in crisis, but also on stock buybacks, dividends, debt and equity considerations, and other ordinary business events.

Significant differences in investment horizon end up looking relatively benign when compared to other forms of conflict that impact any form of shareholder value. For instance, due to a combination of one or various investment techniques—such as short selling, share lending, hedging, or swap agreements—there is often a decoupling between an investor's share title and its economic interest in a corporation. So what appears to be a large owner may only be a renter, with a different agenda. There is a well-documented literature on these practices, which generate compelling reasons for concern. Moreover, the increasing presence of sovereign wealth funds and state-owned enterprises in global

capital markets cause some to wonder whether certain of these new shareholders may come to use their rising influence to promote objectives other than shareholder value. We shouldn't be lulled into a belief that all sovereign wealth funds are alike, or that politics will inevitably play an important role and intrude some of them. This is all too new. But with increasing frequency, potential inter-shareholder conflicts may acquire the nature of a zero-sum game among different shareholders, thus rendering the board's role increasingly complex.

Not only are there various types of actual and potential conflicts arising out of different investment horizons, separation of voting rights and economic rights, and political interests, but the mapping of such conflicts is not simple because such shareholders do not necessarily appear to be what they are in reality. For instance, various surveys have claimed that sovereign wealth funds are essentially long-term passive shareholders, but how can we be certain? We must go beyond the face of the player and investigate who actually "owns" these funds. Families and governments in the Gulf may indeed have long-term interests; there is no way to be confident that other governments will never embrace a political agenda through their shareholdings. In reality, not only sovereign wealth funds and state-owned enterprises but as noted private equity, hedge funds and many other categories of shareholders come in a variety of shapes and sizes, and it is not possible to paint them with one brush.

In addition, the growth of defined contribution plans, mutual funds and derivatives has created an opaque and fragmented investment chain in which company boards can neither see nor understand the values of the shareholders they are meant to serve. And yet the board is to be "fair" to all shareholders. The evolution of the new capital markets, populated with new categories of owners and dangerous weapons, poses profound challenges for boards, regulators, and wider society.

Where does this take us? Although all the new organizations may indeed be technically defined as shareholders, what does each of them value? What is shareholder value between one investor who will profit from driving the share price down, another who wants to take the company private, another looking for instant cash, and one more who is thinking about long-term growth? How do boards serve many masters? Can they do so? Which shareholders? With what intentions? What we are now learning is that the notion that directors owe a fiduciary duty to be “fair” to all shareholders is turning out to be a quite imprecise guide to directors. We are entering new territory.

IV. Conclusion: The Board Now Impacted by the Diffused Values of its Shareholders

The world Jonathan described so well with Anne Simpson seems to me to be fading fast. That was the world of the long-term institutional investor who can be relied upon to hold boards accountable for the long-term value of the corporation, in ways that are largely consistent with the needs of wider society. At present, we live in a world of governance which, in my opinion, confuses, or even obfuscates the meaning of long-term value by the explosion of a complex capital market, now tripped up by its own implosion, leaving us to explore whether our then simple paradigm of governance needs another hard look. I submit, as Rosemary Martin’s example shows, the board today is without guidelines to deal with the impact of this capital market.

My view is that we need to search for better board guidance. Jonathan Charkham would not have flinched from peering into this murk. He would have welcomed the challenge, and the testing of familiar, and comforting precepts. And it is in the spirit of Jonathan’s inquiring mind and passionate commitment to the practical that we should now look at this new capital market and fashion the means to assure ourselves that it operates in a manner which benefits corporate performance.

I am not at all sure where it will take us. Yet some of the lessons of yesterday are today more important than ever; a model of board centrality and traditional shareholder activism is vital to offset the pressures of the current environment.

Society continues to need shareholders who are not passive, but act and vote in a manner supportive of efficient corporate performance, which in turn produces value. Performance cannot depend on shareholders whose only concern is short-term share price movement, or support to any given constituency. Yet, given the diversity of ownership, there must be a process for electing directors who acknowledge the diversity of interests present and are of the caliber and quality needed to exercise their new fiduciary duties in good faith, and thus make the difficult decisions we have described. The current selection and election process needs refinement, and so does the governance of all investors themselves, who, today, too often vote by rote, rather than serious analysis.

Both of these issues are under active study by the International Corporate Governance Network, and I leave them here for another day. Improving traditional shareholder activism is valuable going forward, but not sufficient. The new capital market participants, their financial engineering, and the sweep of global capital need new and innovative solutions.

I see two paths to find innovative solutions:

1. The “right” kind of legislation; and
2. The caliber and quality of boards.

(1) Regulators and market participants alike are questioning the deficiencies of the current system as an aftermath of the financial meltdown which started in the U.S., is rippling through many other economies worldwide, and has not yet come to an end. My less than diplomatic restatement is that we cannot continue to see financial engineering,

as important to the functioning of the market as it certainly is, wagging the tail of the dog of the real world of producing the goods and services which provide the jobs and economic growth vital to the whole world's well being.

Any proposed solutions to these challenges cannot afford to ignore the global character of today's capital markets and economy. Power, capital and consumers are shifting from traditional economic centers to various regions worldwide with little planning or coordination. It may be unlikely for another dominant superpower economically or otherwise to emerge any time soon, but the trend is in the direction of the erosion of any sole superpower as capital markets shift to many different locations.

In tribute to Jonathan's practical mind, we should not seek a response to the existing challenges; we need, and must join efforts to produce and implement, the right response to deal with capital markets which are increasingly global and interconnected, display a wider array of participants with differing strategies and objectives, and employ extremely complex instruments which, if not understood, may lead to disastrous results. In seeking this right response, it is crucial that we ask the right questions and look for the right way to implement a response.

The various new issues in capital markets are intimately interconnected on a global scale and should not be addressed piecemeal. In my view, this needs to be done by the OECD or by a joint effort of international regulators. Analyzing the interaction of the various facets of the same problem will be paramount, since the parameters for regulatory response will need to be designed with the knowledge of and due regard to the full picture. Only such a unitary approach can help avoid the unintended consequences of regulatory action. In view of the need to find an international solution that gives substantial weight to the views of business as the users of capital, the Millstein Center for Corporate Governance and Performance at the Yale School of Management launched its Capital Markets Project, which has been conducting roundtables of focus groups of

private sector participants in markets around the world—such as New York, London, Berlin, São Paulo and Dubai—to understand the new forces which are affecting the global capital markets and to analyze how the various actors—including mainly governments and companies—should respond to such forces. The Center will be of assistance to the OECD’s consideration of these problems.

The right answer to the regulatory effort will need to emerge from an international and coordinated response to the following question:

What does the private sector need from the capital markets in order to promote worldwide growth and the provision of jobs by productive corporations? Productive corporations must no longer be the tail on the dog of the capital market. They warrant primary consideration.

Each separate regulatory effort must fit the answer to that question.

(2) But even with helpful regulatory guidance, the board of directors will be where the difficult issues will need to be decided, and regulation was never intended to, nor could it, deal with the impact of the many factual settings boards face. Hence, the role of the board today is more crucial than ever. Potential intra-shareholder conflicts leave the board with the delicate but critical task of mediating different shareholder concerns and objectives. As a result, boards today need to be ever more nimble, comprehensive, and aware of the complexity of their surrounding environment. Once again, it is up to the board of directors to embody its chameleon-like character and become capable of changing itself over to fit the times. We are really back to the beginning of the corporate governance story—namely the critical role of the board acting to serve the value of its shareholders, this time in an era of diffused values.

Finding, vetting, and electing the high quality and caliber of directors needed for their new role and era remains a matter of concern. It warrants, too, serious study. Executing new concepts of fiduciary duty and good faith is a task for the best we can find.

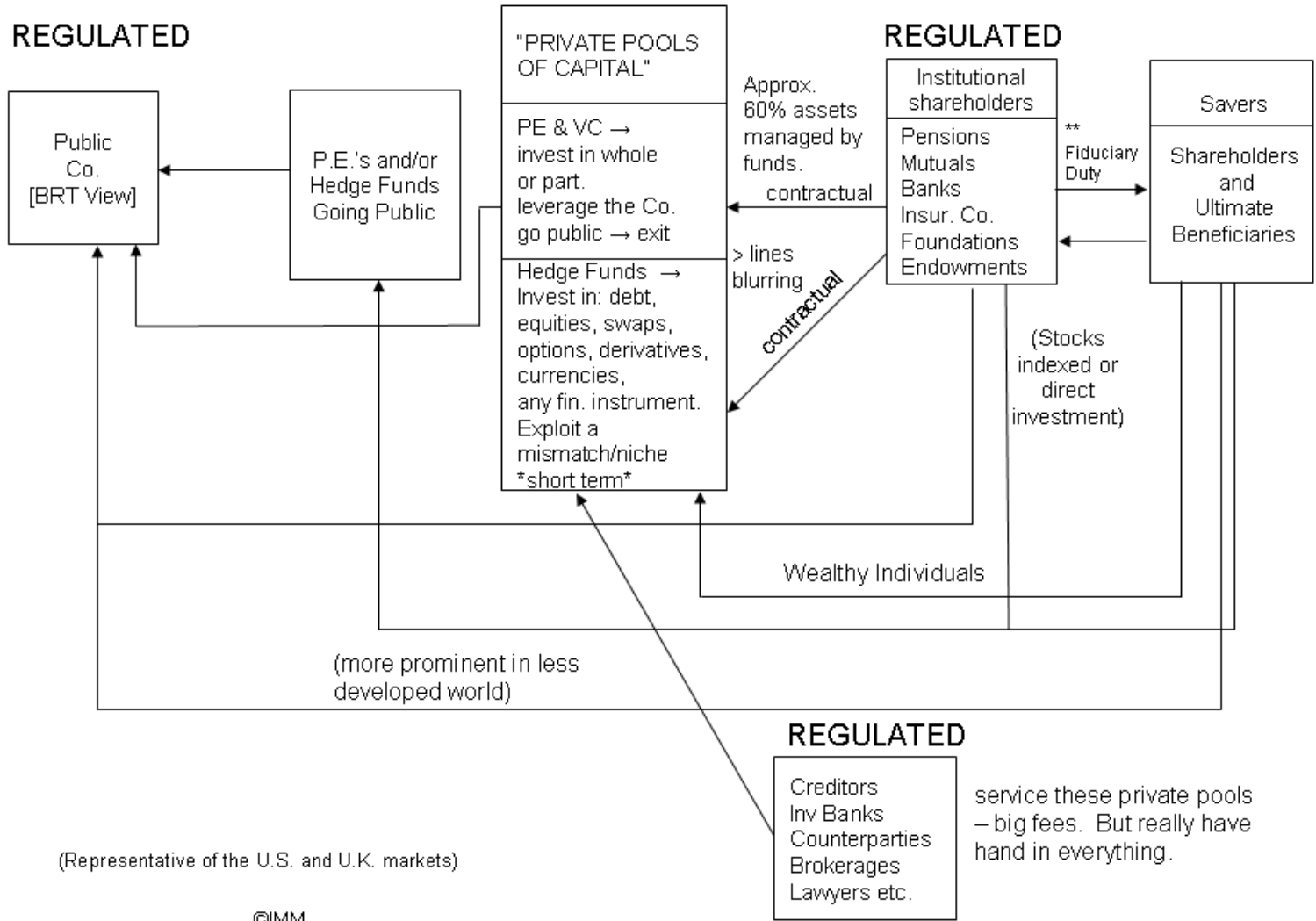
The lawyers are being urged to reconsider the meaning of the board's "fiduciary" duty when the "values" of the shareholders they serve are no longer unitary. Does the concept include "mediation", or deliberately favoring one set of shareholder values over another? Perhaps, but what's the process?

And, beyond the law, which never covers all the factual circumstances, what practical advice can we give boards as they carry out these new responsibilities day-by-day, and case-by-case?

These are the challenges we face—both as to regulation, board practice, and shareholder activism.

Quite exciting, I think.

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