

March 16, 2011

Corporate Governance Adrift

Having served as a member of the NYSE committee that created the NYSE's post-Enron corporate governance rules, I have watched with dismay as those rules have been misunderstood, misapplied and polluted by one-size-fits-all "best practices" invented by proxy advisory services and other governance activists. In the recent Hewlett-Packard case, ISS took the position that the participation by the CEO in the search for new directors tainted the process and warranted a recommendation by ISS for a no vote on the reelection of members of Hewlett-Packard's nominating and governance committee. See March 11, 2011 [memo](#). Apart from the fundamental policy issue as to whether the principal purpose of the board of directors is to monitor the performance of the CEO or to advise as to strategy, the Hewlett-Packard case raises the equally important issue of how the board should function on a day-to-day basis.

The Independent Committees

The corporate governance rules of the NYSE require listed public companies to have a board consisting of a majority (not a super majority) of independent directors and an audit committee, a nominating and governance committee, and a compensation committee, each consisting of only independent directors. In addition, the audit committee must have sole authority to select the independent auditor; the nominating and governance committee sole authority to select a search firm to identify candidates; and the compensation committee sole authority to determine the compensation of the CEO and select a consultant to the committee. There is nothing in the NYSE rules that precludes the CEO, other officers, and other non-independent directors from attending a committee meeting, making a recommendation to a committee, or requesting that any matter be discussed by the full board. The only requirement is that the final determination of matters as to which a committee has sole authority be made by the independent directors who are members of the committee.

The NYSE rules also require each of the independent committees to have a charter. The charter, as originally adopted by the entire board, is subject to amendment from

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time-to-time by the entire board. Thus, so long as the specific matter as to which the committee has sole authority is preserved, the authority and procedures of a committee can be expanded or narrowed by action of the board. To the extent that practices have developed or charters drafted that go beyond the NYSE rules, the full board should reexamine them to determine their utility. So, too, proxy advisory services and organizations like the Council of Institutional Investors should reexamine their policies and one-size-fits-all best practices.

It is not in the interests of shareholders for these advisory services to attempt to impose practices that are counter-productive. Nor is this in the interest of the institutional investor clients of proxy advisors; they owe a duty not to slavishly follow advice from such services, but to determine whether or not that advice is beneficial to a corporation and its shareholders. This is particularly true with respect to compensation. Institutional investor clients that rely on advisory services and routinely apply the advisory services' inflexible metrics and formulae to compensation programs, ignoring the careful consideration and well-founded determination of a compensation committee, do substantial damage to the company by undermining its ability to attract and hold the best talent. Enactment of the pending proposal by the Department of Labor to impose ERISA fiduciary duties on proxy advisors would be a major advance in dealing with this problem, as would SEC regulation of proxy advisors.

The Executive Session

The NYSE rule mandating regular executive sessions of the non-management directors has resulted in an unintended dual-board structure in a significant number of corporations. First, there is the regular board meeting; then immediately after, there is the executive session. Originally intended to provide a formal opportunity to discuss privately concerns about the CEO, at many companies this session has deteriorated into a second discussion and critique of what transpired at the regular meeting. Given the exigencies of time and the reluctance of some directors to directly confront the CEO, this has the effect of shifting hard and challenging discussions of performance and strategy from the regular meeting, where they belong, to the executive session, with the concomitant danger of the CEO and management receiving only a diluted version of the concerns expressed when the director who presided over

the executive session reports to the CEO on what transpired. When this happens, it can result in a significant waste of valuable time and lead to serious misunderstandings. It would be sufficient to schedule executive sessions for every second or third board meeting and limit the agenda to CEO performance or any material matter a director may wish to raise and to avoid rediscussing much of what was covered in the full board meeting. Additional sessions, of course, could always be added, but only on an as-needed basis.

Independent Directors and Friends

Lastly, friends can and should be independent directors. There is absolutely no basis for second-guessing a board's reasonable determination that a friend of the CEO, or a friend of another director, is independent. Also, as long as a majority of the board is independent, the other members can be men and women who are not independent and who bring special skills, experience, or other qualities that are important to the board's understanding and monitoring of the corporation's business and risks. An example is the recent realization and acceptance of the need by banks for directors with banking and finance experience, even though not independent. When I'm asked by a person whether she should accept an invitation to join the board of a public company, I respond that she should recognize that her reputation (and, while unlikely, her pocketbook) will be dependent on the culture of the company, the ability of the CEO and whether the board she is joining is a collegial body of experienced strong-willed people who will stand up for what they believe to be right. This assessment is not feasible, and ultimately the effective functioning of the board is often impaired, if everyone is a stranger.

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