

# A 10-year quest for director accountability

*How the first three stages (1987-1997) of institutional activism evolved, and what's needed next for directors to regain investor confidence.* **BY JOHN C. WILCOX**

**T**EN YEARS AGO, in the spring of 1987, corporations faced a new kind of investor activism for the first time. In that year, the California Public Employees' Retirement System (CalPERS) introduced shareholder proposals seeking rescission of poison pills at 30 companies — the first sponsorship of governance proposals by a public pension fund.

The event was not initially recognized as the birth of a new movement. Corporate America was deeply involved in a debate over the validity of hostile takeovers, and commentators saw institutional activism as a reflection of fiduciaries' legal responsibility to maximize value. The governance implications were largely overlooked.

But the warning signs were immediate. The 30 CalPERS proposals scored favorable votes averaging 20.5% of outstanding shares, easily surpassing the minimum statutory resubmission requirements that had defined the success of gadflies and social activists for years. The vote results were both shocking and revealing. Until this time, corporations had not understood the consequences of changing shareholder demography. Despite the well-documented shift in ownership from individuals to institutions, many corporate executives still clung to the notion that shareholders should sell their stock if they were disappointed with performance. Managers did not take seriously the claims that institutions were too big to get out of a stock easily, that indexing would not permit it, and that size and

portfolio theory dictated that they act as “permanent” owners.

A decade later it is clear that institutional activism, even more than takeovers, has had a defining influence on Corporate America. Activism has changed corporate culture, effected a redistribution of power between managers and shareholders, and served as the driving force behind the search for greater accountability in corporate governance.

## Stage One

The evolution of institutional activism falls into three distinct stages. During the early years (1987-1990) activists were intensely focused on takeovers and control. Proposals were designed to eliminate poison pills, golden parachutes, greenmail, fair price provisions, and other defensive practices that shareholders felt infringed on their rights and reduced the value of their investment. But activists were also pursuing a more important objective: defining a role for shareholders in corporate decisionmaking.

In their search for validation and public recognition, activists were not ashamed to use hyperbole and aggressive public relations to enforce “governance by embarrassment.” They targeted companies with high institutional ownership to ensure consistently high votes. They promoted themselves as underdog representatives of small investors. They lobbied Congress and the SEC relentlessly — and effectively — to capitalize on the securities laws' mandate to protect small investors from large, economically powerful corporations. With help from such diverse groups as the Council of Institutional Investors, T. Boone Pickens' United Shareholders Association, and such visionary thinkers as Robert A.G. Monks (founder of Institutional Shareholder Services, the proxy adviser to institutional investors), activists ran circles around corporations both in Washington and in the media.

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While activists went about their campaigns with energy and creativity, corporations seemed unable to assemble an effective response. They lacked a collective voice to explain and defend the merits of corporate structure and practices. When The Business Roundtable produced thoughtful commentary, activists quickly characterized the organization as an elitist representative of powerful CEOs, out of touch with the needs of shareholders. In the end, there was simply no leader to speak on behalf of corporations, and the ensuing debate was largely one-sided: “the people” versus faceless corporate monoliths.

**Stage Two**

The second stage (1990-1992) centered on reform of the proxy rules. Again, CalPERS played the leading role. On November 3, 1989, CalPERS General Counsel Richard H. Koppes sent a 25-page letter to Linda C. Quinn, Director of the SEC’s Division of Corporation Finance, proposing 48 specific reforms to the proxy rules. The purpose of the proposals, as stated by CalPERS CEO Dale M. Hanson in the letter, was “. . . to stimulate a broad reevaluation of the system which defines the practical contours of the role of shareholders in the governance of public companies.” This initiative was a shot across the bow of Corporate America.

The national debate over proxy reform lasted three years. More than 1,000 comment letters were received by the Commission — a higher response than on any previous issue. The scope of opinion revealed how much the principles of governance were of deep public concern. The debate was not just about the proxy rules; it dealt with the distribution of power, the use of checks and balances, the protection of basic economic and procedural rights. Ultimately, it was about fairness and due process — core values essential to any governance system, corporate or political.

In the end, shareholders achieved nearly everything they asked for. The proxy rule amendments were issued on October 6, 1992. In the words of then-SEC Chairman Richard C. Breeden:

The new rules will . . . enable shareholders to communicate with each other **and the board** without unnecessary interference or costs. Those who are not soliciting proxies for themselves, and who do not have any other special interest in the election, will be *exempt* from the proxy rules except for a simple prohibition against fraud. Shareholders will be completely free to publish their views in the press or the media without the SEC’s permission. Small shareholders will also be completely free to

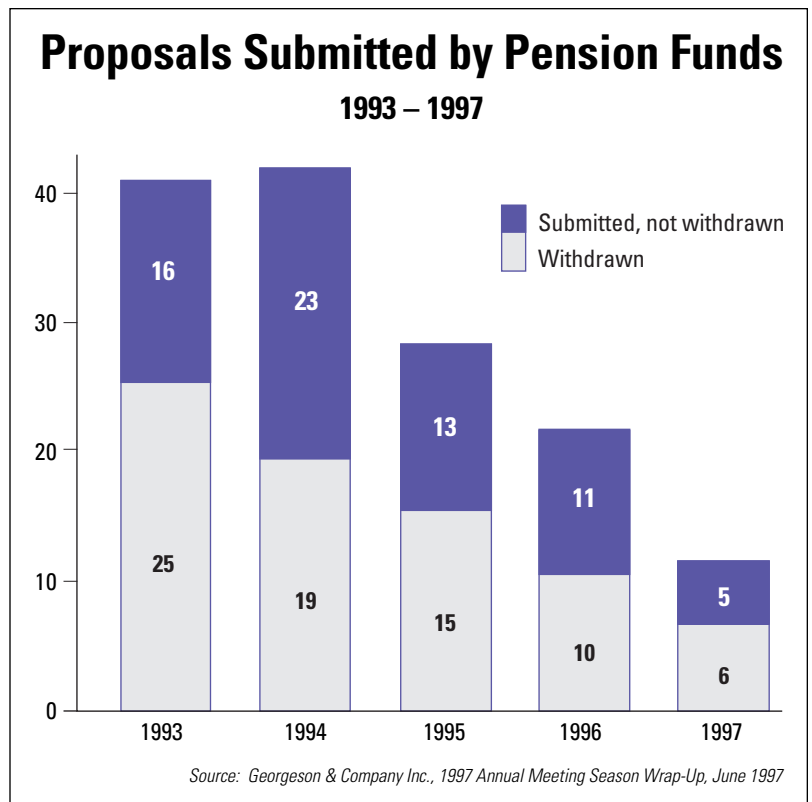
communicate directly with one another. [Author’s note: italics original, boldface added.]

In addition to liberating shareholders from the proxy rules, the 1992 amendments imposed two new requirements for disclosure in proxy statements. First, each company was required to prepare a five-year graph charting its stock’s performance against a market index, such as the S&P 500, and an index of industry peers. Second, each company was required to include a report from its board’s compensation committee describing the policies and “performance factors” on which the directors based their decisions. Of the compensation committee report, Chairman Breeden said:

***In a governance system built on the principles of full disclosure and open communication, the silence and invisibility of directors is a glaring anomaly.***

That report to shareholders will appear — before the annual election of directors — over the names of the people who actually made the [compensation] decision. Then, judging the appropriateness of the directors’ decision should be up to the shareholders . . . Armed with information and empowered to act on

Exhibit 1



that information, market forces should hopefully restore a better sense of balance to America's boardrooms.

### Stage Three

These two issues — financial performance and board accountability — dominate the third and current stage of institutional activism. Chairman Breen's important but little-noted assertion that shareholders would be empowered to judge directors' decisions and that "balance" would be restored to America's boardrooms proved to be highly predictive of activism's search for director accountability.

Institutional activism today is fundamentally different from the combative free-for-all of the movement's early days. Activists' goals, as well as their tactics, have matured. Proponents now target companies either for poor financial performance or

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egregious governance practices. The selection process, which utilizes quantitative performance measures and checklists of governance policies and standards, has become a central activity in activists' self-defined role as corporate overseers.

The annual publication of the Council of Institutional Investors' "Focus 20" list of targeted underperformers is one of many such governance media events.

Shareholder proposals are no longer activists' sole focus, and proxy votes no longer the primary measure of their success. The shift from main act to sideshow is clear from statistics on shareholder proposals shown in Exhibit 1: since 1993 there has been a steep decline in the sponsorship of shareholder proposals by public pension funds. As soon as activists won a place at the bargaining table, many of their most aggressive tactics moved beyond the proxy process. Negotiation is now their goal, and success is measured in terms of actual changes adopted by targeted companies. Proxy solicitation remains the most potent weapon in the few cases where negotiations fail.

Activism's growing focus on financial performance has transformed both the dialogue and the level of cooperation between companies and large activist institutions. Corporations have increasingly been willing to engage in substantive discussions with investors about matters of business strategy, performance, and market value. These negotiations have in turn led companies to reassess the importance of their dealings with institutional activists.

Many companies have shifted responsibility for these relationships from shareholder relations to investor relations departments — a significant step up the corporate hierarchy. Shareholders now often receive the same level of attention as securities analysts and portfolio managers. Whether or not companies buy into the theory that good governance improves performance, they no longer deny that activist investors are an important constituency.

### Activism and the board

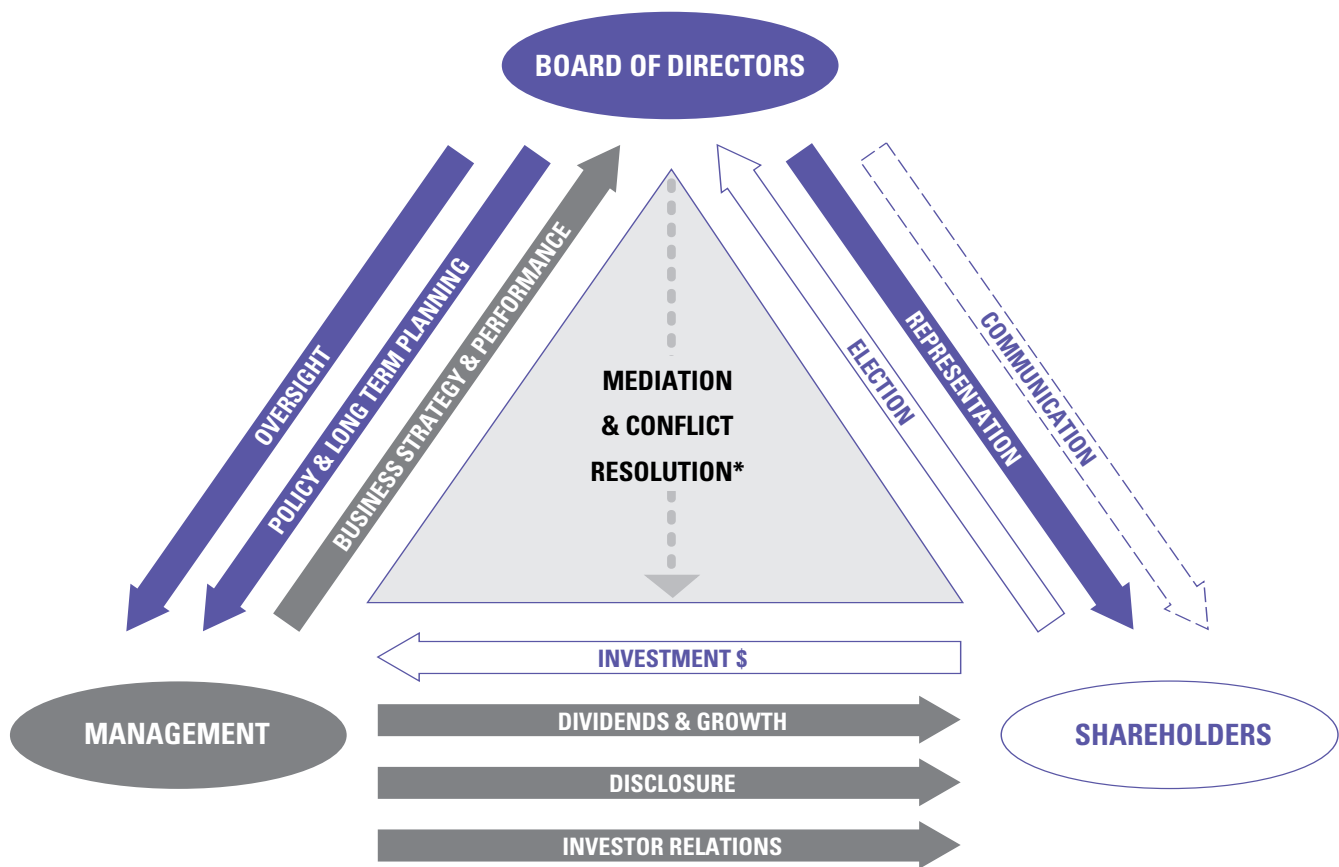
SEC Chairman Breen's vision of communication between shareholders and boards has not been realized. The 1992 rule changes succeeded in liberating shareholder communications but did not address the regulatory scheme's most serious design flaw: the lack of a voice for directors. In a governance system built on the principles of full disclosure and open communication, the silence and invisibility of directors is a glaring anomaly.

There are cultural and historical reasons why our system has tolerated and even encouraged the insulation of corporate directors. Many are rooted in competitive concerns or in the need for confidentiality in M&A and takeover transactions. But even aside from these considerations, the concept of nonprofessional board service is qualitatively distinct from the rest of the U.S. governance system. The idea of "service" defines the special status of the board. Corporate executives join boards not for the compensation, not because they have idle time, not because they hope for business gains, but because they seek professional enrichment. This subtle arrangement has contributed greatly to the quality of boards but has left them in a peculiarly undefined state, in which key questions of accountability are neither asked nor answered.

To activists, boards seem like a last vestige of nobility — encased in protocol, shielded by advisers, operating in secrecy, out of touch with the electorate, and trotted out on ceremonial occasions. Recent criticism of the British royal family's aloofness and lack of common touch are remarkably similar to shareholders' complaints about corporate boards.

The heart of the problem was summarized in a recent *Business Week* article on corporate governance: "Investors simply cannot tally the benefits of a strong board of directors . . . because what goes on in the boardroom is invisible to outsiders." Shareholders' efforts to penetrate the boardroom have been notably unsuccessful. Activists first tried to set up shareholder advisory committees — a mix of directors and key shareholders meeting periodically to discuss shareholder concerns. The idea

## The Corporate Governance Triangle



\* The board is responsible for resolving the structural conflicts that arise between the conflicting but equally valid goals of management and shareholders on the following issues:

- Control
- Capital Structure
- Compensation of Senior Management
- Nomination of Directors
- Shareholder Rights

Source: Georgeson & Company Inc.

Exhibit 2

was abandoned for practical reasons: neither directors nor institutional investors were willing to participate. Then “relational investing” became the rage, particularly among academics. But its assumption that institutional investors could behave like owners quickly failed. Investment managers realized that their fiduciary responsibilities and financial goals would conflict with long-term ownership commitments.

Having failed to establish an oversight mechanism, shareholder activists turned to the articulation of detailed standards for board structure and director independence. CalPERS, TIAA-CREF, the Council of Institutional Investors, and even some professional associations such as the National Association of Corporate Directors have published lists of criteria, standards, and policies to evaluate directors and boards. This approach, which relies

on external measurement, conspicuously overlooks the most important qualities needed in every board member: experience, business skills, integrity, ethics, skepticism, toughness, passion. These qualities cannot be measured, standardized, packaged, or put on lists. Character traits readily discernible by those inside the boardroom are invisible to those outside.

### The visible board

Since external accountability mechanisms are inadequate, directors must take the initiative to define their role and tell shareholders how they are doing their job. The boardroom door must be opened — not to admit shareholders but to let directors step outside.

Three practical changes can help directors tell their story and regain investor confidence:

First, *directors must clearly define their responsibility for bridging the gap between owners and managers.* A board that functions independently of both owners and managers holds answers to the conundrum of absentee ownership — how to reconcile the demands of shareholders and professional managers and protect the interests of absentee owners. Since institutional activism has established shareholders as a power base on a par with managers, the board’s governance role has actually become more clearly defined. The board must mediate and resolve conflicts, and the topics on which shareholders and managers will consistently disagree actually comprise a checklist of key governance issues: takeovers and control, executive compensation, capital structure, CEO succession, board nomination, shareholder rights. (See Exhibit 2, “The Corporate Governance Triangle.”)

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Second, *boards must have access to information about the corporation’s ownership and market value.* Directors need to know as much as possible about the constituents they represent. Through investor relations departments, the board can obtain periodic reports outlining who owns the company, how the ownership profile compares with peers, what the differences mean, how the ownership is changing, how valuation is affected by these changes, and whether the company’s fundamentals are fairly reflected in its stock price. Directors should also review sell-side analyst reports and other third-party evaluations of the company. When considering strategic business decisions, directors should have access to data that predicts how ownership and stock price will be affected. Without such data, di-

rectors cannot effectively represent the interests of shareholders or help guide the company to maximize value.

Third, *directors need a voice.* In its quasi-judicial role mediating between owners and managers, the board must have a way to communicate its reasoning and conclusions. No court can function without written opinions. The compensation committee report mandated by the 1992 proxy rule amendments provides boards with an appropriate communication model. A compilation of such reports from all the board’s standing committees, plus ad hoc reports on extraordinary decisions involving governance and strategic planning, would constitute an annual DD&A (Directors’ Discussion and Analysis) of great value to shareholders. Disclosure and communication impose their own form of discipline. The report of the compensation committee compels directors to ensure that their compensation policy reflects performance. A DD&A published annually in the proxy statement would be an effective accountability mechanism for boards — self-imposed yet responsive to shareholder concerns.

**The next step**

E. Norman Veasey, Chief Justice of the State of Delaware and a leading authority on securities law, describes the board’s governance responsibilities in the following terms: “The board must be engaged in actual governance — not merely advisers to the CEO — of the business and affairs of the company. This . . . does not mean running or operating the business. It does mean functioning forcefully on ownership issues . . .” (*The Corporate Governance Advisor*, July/August 1997). A decade of institutional activism has brought these ownership issues squarely into the boardroom. The next step is for directors to find ways to communicate how they are conducting the “actual governance” of the company. Shareholders’ demands for accountability can be satisfied only by the directors themselves.