Behind the call for better corporate governance

Stephen Davis and Jon Lukomnik | November 22, 2016

Times certainly have changed. Many CEOs greeted corporate governance demands with choice four-letter words in recent years. So it was remarkable when, on July 21, a small cohort of America's best-known business leaders penned their name to the "Commonsense Corporate Governance Principles," covering topics from executive pay to board composition. Signers were careful not to label it an authoritative national code, such as those developed in nearly every other major market. But the text is as close as the United States has yet come to one. With the initiative now digested in the market, it's time to review what the new principles got right and what's needed to make them take root.

Our overall take is that the Commonsense Principles are heading in the right direction. They are far from comprehensive, and they wobble occasionally between pointing where companies should go, finding feeble middle ground, and simply describing practices that now prevail. Most importantly, they are silent on how to make the guidelines a living document that can make a difference. But they are a welcome first step.

Before examining the substance of the Principles, though, let us address a bedrock question: What good might come from principles or a code addressing how companies should act in governance? Aren't Securities and Exchange Commission (SEC) regulations and stock exchange listing rules enough to keep track of? The answer is that voluntary guidelines on best practices are more flexible than statutes and rulebooks. Indeed, experience elsewhere is that codes can help markets *avoid* piling on more prescriptive law and regulation. That's why at least 90 countries, beginning with the U.K.'s Cadbury Code in 1991, have made such guidelines a central feature. Take a specific hypothetical. Had corporate executives and investors had a mechanism to agree among themselves on a compromise proxy access formula, we might have avoided divisive and costly battles in Congress, the courts, and annual meetings, on the matter. Other real-world examples abound abroad. Most recently, Britain chose to embed calls for board diversity in its voluntary corporate governance code rather than follow the route other European nations took to install gender quotas in law.

Simply put, getting companies, investors, and other stakeholders in a room to discuss best-practice frameworks, that can then be changed more flexibly, mitigates confrontation. Relying solely on law, which carries with it criminal penalties and civil liability, hardens lines. We can envision plenty of disputes that could benefit from the mediation effects of a code, such as whether and how public companies should disclose political contributions, or (now-legislated) conflict mineral disclosure.

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Of course, there's another answer, too, to the question of what good a code might serve. And it's one that might be the unstated driver behind rising corporate interest in U.S. principles. Without a code, standard setting on what is best practice in governance defaults to the two principal commercial proxy advisers, Institutional Shareholder Services (ISS) and Glass Lewis. In other markets, proxy advisers go about testing how companies measure up against prevailing national codes, adding their own judgments, and then recommending to investor clients whether to approve or reject corporate proposals. In the United States, without a code, the advisers must do double duty: They develop their own best practice standards and then recommend how companies perform against them. To be sure, ISS and Glass Lewis might be better described as standard takers than standard setters, in that they write voting guidelines in consultation with investor clients. But it is hardly surprising that companies are increasingly fed up with having to meet governance goals codified by two vendors who have only investor clients and, in which, companies have minimal say. We don't even think the proxy advisers are happy with the way things are. They would likely prefer to have companies and investors determine best practices, leaving them to judge how firms measure up.

That's why, in July, the likes of Blackrock's Larry Fink, State Street's Ron O'Hanley, Vanguard's Bill McNabb, Capital Group's Tim Armour, and T. Rowe Price's Brian Rogers joined with Mary Barra of GE, Warren Buffett, Jamie Dimon of JPMorgan Chase, and Jeff Immelt of GE, to sign the Commonsense Corporate Governance Principles.

Did they offer any surprises? Not really. In nine pages the signers agreed on practices already largely followed by companies and investors in the United States. Where controversies exist, they found a safe, even muddled, middle. Should corporate directors be loyal to the company or the shareholders? The Principles say both. Should directors be diverse? Yes, says the document, that's "critical to a high-functioning board." But it offers no suggestions for how to accelerate the snail's pace of change at U.S. public company boards. And it cautions that boards should temper pressure to refresh membership with the need to retain age and experience. Should directors talk to shareholders? The Principles only say that some companies allow them to do so. Should the outside chair or lead director, not the CEO, set the board agenda? The guidelines say only that the board "should have input" into the agenda. Executive pay? The Principles urge each board to consider paying senior managers a "substantial portion" in equity with a vesting period aligned with long-term performance. Proxy access? Guidelines merely state that some companies have adopted provisions allowing shareholder nominations. Separate board chairs? The Principles assert that the board should decide whether or not to split the chair and CEO roles.

Signers did go out on a few limbs. They say explicitly that every company should conduct director elections using majority voting. They favor rotating lead directors, where they exist, even though some investors find rotation weakens the office. They say no to dual class voting. They recommend that companies "not feel obligated to provide earnings guidance." And finally, they extend the principles to cover investors. Noting the importance of governance "to long-term investment success," the document urges institutions to devote resources to voting and engagement and to make their own judgments, even while utilizing proxy advisers.

An outcome of compromise, there is no doubt that some in the market are unsatisfied. In fact, another set of principles authored exclusively by investors is said to be due out by year-end that may look different. But the biggest gap may be not in content, but in process. "Codes of Corporate Governance: A Review," a working paper released in 2012 by the Millstein Center for Corporate Governance and Performance, then at Yale, found that, in Europe, codes had greatest long-term traction, first, when they were developed by diverse stakeholders, and second, when they included an ongoing monitoring body to promote take-up and sponsor revisions as market conditions and opinion evolve. The Commonsense Principles, by contrast, were developed in private by an exclusive group of 13 leaders from large corporations and mutual funds, one Canadian pension plan, and one activist investor. U.S. public funds—which have largely driven the governance debate through pushing such issues as proxy access and majority voting—are not on the signatory list, nor are director groups or auditors. There was no open consultation process to ensure that a broad set of voices were heard.

More troubling, the principles are a one-off. There seems no provision so far for ongoing monitoring of adoption or mechanisms to revise the recommendations over time, as capital markets and governance philosophies change. For instance, while the document is now neutral on splitting the chair and CEO roles, we forecast that investor opinion in favor of splitting is likely to harden in the near term. If the principles fail to reflect such change, they will quickly become obsolete.

Fixes are doable. It's not too late for signers to invite more interests into the tent and to name an independent monitoring body. If they do, chances are greater that the Commonsense Principles could earn trust from both companies and investors, shift standard setting away from proxy advisers, and help discourage prescriptive lawmaking in the new Congress. That's a prize worth the work.

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