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## COURAGE, CANDOR AND CONSCIENCE

THE RISE OF PRINCIPLES-BASED GOVERNANCE

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### CORPORATE GOVERNANCE WILL NEVER BE THE SAME

The past few years have seen epic corporate scandals and failures. The media, governments and analysts of many stripes have pored over, picked through and reported on what went wrong. Governments and regulatory agencies are rapidly enacting new laws and guidelines. Companies have rushed to restate earnings in record numbers. Securities and Exchange Commission (SEC) and Justice Department investigations and indictments have increased, and people are going to jail.

But that is just the tip of the iceberg, the public spectacle.

On a quieter front, the boards of virtually every public company are reviewing every aspect of governance to assure compliance with new laws and guidelines from the SEC, New York Stock Exchange, NASDAQ, Institutional Shareholder Services and others.

It is safe to say that governance will never be the same. Public companies have been thrust into an era of rule-based governance as boards look for vulnerabilities and ways to improve their governance policies and practices.

However, surveys show that the large majority of executives believe they are in compliance. So why the concern?

First, of course, they must exercise due diligence to *prove* they are in compliance with all regulations, existing and imminent. But simply complying with the rules no longer ensures that companies will stay out of trouble or that boards will get relief from investor scrutiny. There is a qualitative shift in the type of rules being invoked and the spirit in which they are enforced.

For example, the courts are warning that directors may no longer be responsible merely for the process of their decisions but for the decisions themselves, opening up a whole new interpretation of the “duty of care” rules under which they have always operated.

From June 2002 to December 2003, the Delaware Supreme Court ruled in favor of shareholders—reversing lower-court decisions in favor of directors—in five out of five cases involving performance by directors of their fiduciary duties.

E. Norman Veasey recently retired as supreme court chief justice in Delaware, the state in which the largest number of U.S. companies have chosen to incorporate. He was quoted in the *ABA Journal* in September 2003, saying, “[W]e use common law. The common law is always evolving . . . so, the expectations of directors are always evolving.” If the past few years have taught corporate leaders nothing else, they have learned that, legalities aside, the standards of conduct and good governance can change in an instant and the deeds of yesterday will be judged by the standards of today.

In addition, there is the spirit of the new regulations, most notably the Sarbanes-Oxley Act of 2002, which is to restore investor confidence in public markets. Even in companies where strict compliance with new regulations is not in question, boards are challenged to demonstrate good governance practices—above and beyond what is required by law—to reassure shareholders that the company is not vulnerable to the devastating effects of a scandal.

Thus, it is crucial for directors to resist the natural urge towards simply reviewing checklists of policies and processes, and instead opt for a more global approach called “principles-based governance.”

The goal of principles-based governance is the holistic focus on fulfilling the board’s fiduciary role on behalf of investors to help the company achieve its potential and maximize shareholder value in a responsible and sustainable way. Principles-based governance addresses not only the fact of good governance but also the awareness of it.

Research shows that investors reward good governance. In July 2002, McKinsey & Co. found that institutional investors place equal weight on governance and financial measures when making investment decisions. The survey also found that evidence of strong governance practices resulted in

stock price premiums averaging 12 to 14 percent in North America and Western Europe, 20 to 25 percent in Asia and Latin America, and more than 30 percent in Eastern Europe and Africa.

So how can directors practice principles-based governance? It starts with three principles: courage, candor and conscience. It takes courage to challenge established ways of doing things or to push back against the momentum of a group of peers once they are moving in a certain direction. It requires candor to speak up when something doesn't sound right or there isn't enough information to support a decision. And it requires conscience or integrity—the overall drive to do the right thing at the highest level rather than take the short-term, easy-way-out, no-one-will-know-the-difference approach to guiding a company.

The following are some areas in which corporate leaders can make a substantial difference in actual and perceptible principles-based governance.

#### EXECUTIVE COMPENSATION

Executive compensation is perhaps the most hotly contested and emotional issue separating shareholders and corporations today. The media have fanned the flames by spotlighting the most egregious abuses of compensation to the point where this issue has penetrated public awareness and further eroded trust in public corporations—despite the fact that these extreme cases are the exception rather than the rule.

In fact, in his remarks to the National Association of Corporate Directors' (NACD's) Corporate Governance Conference in October 2003, William McDonough, chairman of the Public Company Accounting Oversight Board, warned that boards may find themselves eye-to-eye with Sarbanes-Oxley II, III and IV if the issue of executive pay is not addressed.

Clearly, the pressure is on, and executive compensation ranks high as a concern among corporate boards.

In December 2003, the NACD completed a governance survey of nearly 600 directors of public companies, as well as proxy filings of more than 5,000 companies. The survey found that more than two-thirds (68.6 percent) of directors feel that CEOs of major public companies are paid too much in total compensation in relation to their performance. Some executives have

garnered enormous wealth that has little, or even negative, correlation with their contribution to the long-term performance of their companies.

The reasons given by survey participants regarding why CEOs may be overpaid include the following (they could choose more than one):

- Conformist board; tendency to benchmark (keep up with other companies)—64.7 percent
- Poor advice from compensation consultants—41.8 percent
- Aggressive CEO negotiating stances—37.5 percent
- Lack of director education on compensation issues—34.5 percent
- Too many CEOs on board, creating a club mentality—20.7 percent
- Poor disclosure of compensation (accounting for options)—14.8 percent

Other reasons included fear of losing executives, greed on the part of executives, and weak or nonexistent performance metrics.

Still, it is a challenge for boards to devise compensation programs that will consistently reward the right behaviors, which should contribute to better company performance and increased shareholder value, as well as consistently discourage undesirable behavior.

Although one of the most important roles of a board of directors is to ensure that the company's management has the skill, integrity, experience and diligence to lead the organization to success, boards must balance the need to attract top talent in a competitive market with the need to avoid compensation that is vastly out of proportion with the salaries of company management and employees in general. This responsibility usually falls to the compensation committee.

The NACD recently issued a report by its Blue Ribbon Commission on executive compensation and the role of the compensation committee. In it, the commission recommends “a compensation philosophy and related practices that reflect the principles of independence, fairness, long-term shareholder value, link to performance and transparency.”

By following the suggested practices and tools provided throughout the report, compensation committees and boards can make a critical difference in the future of individual companies and in the future of corporate governance in general. Courage is the key, and the time to exercise it is now.

**SHAREHOLDER COMMUNICATIONS REGARDING  
ACCESS TO BOARD NOMINATIONS**

Board independence is currently a matter of vigorous debate. Many new regulations and guidelines are coming to the fore to deal with this issue. The NACD governance survey found that 92.4 percent of directors say their boards already conform to the requirements proposed by the stock exchanges for a majority of independent directors on the board.

Furthermore, the survey shows a significant increase in board independence since 2001 (*see Figure N<sup>o</sup>. 1*).

*Figure N<sup>o</sup>. 1*

**BOARD INDEPENDENCE**

<b>BOARD INDEPENDENCE</b>	<b>2000</b>	<b>2001</b>	<b>2003</b>
> half independent	54%	61%	73.8%
> three-quarters independent	28%	29%	34.1%
≥ half insiders or affiliated outsiders	46%	39%	26.2%

*Source: 2003–2004 NACD Public Company Governance Survey,  
National Association of Corporate Directors, December 2003*

So although boards in general are doing what they can to mitigate shareholder concerns about collusion, a recent case in which Roy Disney and Stanley Gold resigned from Disney's board of directors highlights the shortcomings of rule-based governance in contrast to principles-based governance.

In short, Messrs. Disney and Gold allege that the rules regarding inside directors were used against them. Whether it is true or not, the point is inescapable that adherence to rules about independence does not guarantee good governance, and conversely, insider directors don't necessarily undermine governance. This demonstrates that directors must exercise independent-mindedness in addition to adherence to rules.

Many shareholders are frustrated by their lack of visibility and control over the relationship between them and their elected representatives, the board. Few companies create a forum for shareowners and independent directors to meet and discuss issues. In fact, some companies have had policies against such interactions. Some haven't required directors to attend annual

shareholder meetings. Some haven't even allowed directors to respond to questions or concerns from shareholders.

Not surprisingly, many shareowners have felt they have no input into selecting nominees to their boards, little influence over their election and no hope of engaging in a dialogue with them. Without any indication that their views would be welcome or heard, it is natural that many shareholders have not felt represented in the boardroom.

Clearly companies need to go beyond the rules in the process of bringing new directors on board and in setting guidelines for how shareowners and boards should communicate about this important issue. Case in point: A federal court in Houston recently granted plaintiff stockholders the right to nominate two candidates to the board of Hanover Compressor, as it negotiated a judgment on an insider trading case.

As of January 1, 2004, the SEC stiffened disclosure rules related to nominating committees and board nominees, requiring companies to disclose:

- Whether they have (or plan to form) a nominating committee
- The nominating committee's charter, if any
- The nominating committee's processes for identifying and evaluating candidates
- The minimum qualifications for a nominee recommended by the nominating committee, and any qualities and skills that the nominating committee believes are necessary or desirable for board members to possess
- Disclosure of how shareholders may communicate with directors, if at all

As this book goes to press, the SEC is considering requiring companies, in some situations, to include in their proxy materials board candidates who are nominated by shareholders.

In addition, the New York Stock Exchange amended its listing standards, requiring companies to disclose a method for interested parties with concerns to communicate directly with either a designated "presiding" nonmanagement director or the nonmanagement directors as a group.

Beyond these rules, an ongoing task force between the NACD and the Council of Institutional Investors has developed a set of principles-based

practical recommendations to help companies implement better systems for shareholder communications. The forthcoming report offers ways for boards to be proactive in shareholder communications—a better alternative than prescriptive, regulatory actions designed to solve problems that may have been avoided through better communication in the first place.

These best practices include ongoing programs for comprehensively disclosing important management and board issues, such as financial information, policies and practices, and frequently asked questions. These can be in the form of Web communications, newsletters, press releases, and so on, as appropriate. Communications should be clear and uncluttered.

Contact information should be available for the corporate secretary and at least one independent director. Without staff to support them, it is probably not practical to make all directors responsible for routine shareholder communications, but it is recommended to make committee chairs available and to encourage shareholders to contact any director in matters of potential wrongdoing or questionable practices.

Boards should outline appropriate topics for communication with the board as opposed to company management. These should include core issues involving corporate strategy—such as mergers, acquisitions, divestitures and capitalization issues—as well as governance. In addition, boards should identify what metrics should be reviewed in those communications and direct management to tie them to performance indicators.

Boards should implement and disclose policies regarding all forms of communication, ranging from in-person meetings to electronic and written communications. Policies should ensure that directors are informed of shareholder appeals and will make a good-faith effort to respond in a specified mode and time frame.

Finally, boards should commit to keeping policies and practices up to date and effective. Shareowner communications should be considered a critical and ongoing process, which, if left unattended, will fail.

#### DIRECTOR EDUCATION

Directors agree that expertise as a director is an important trait for board candidates, ranking second as first choice (after integrity) from a list of

competencies in the NACD governance survey. And yet there are no regulatory requirements for ongoing education or certification of directors.

Survey participants did not agree on one method of formalizing educational requirements, such as mandating attendance at approved programs, certification of directors based on set standards of knowledge or experience, or accreditation for directors by a recognized organization. However, they clearly value increasing director skill and knowledge through continuing education.

Director education is in greater demand, not only by directors themselves; it is becoming a greater priority for corporations, as well. The demand for director education at the NACD has risen dramatically—particularly for programs delivered inside the boardroom—on every topic from board best practices to financial literacy and committee responsibilities. Education is perhaps the area where going above and beyond rule-based requirements can add the greatest value to organizations, as well as minimize the risks to directors and companies.

There are several dimensions to board education. Obviously, staying current with the literature and participating in events geared towards board governance and management issues are key. However, companies themselves can be more proactive in providing directors with greater clarity on what is happening inside the company—not just in finance but in operations, employee and customer relations, and so on—to provide the insight they need to increase board performance and better fulfill their fiduciary responsibilities to shareholders.

Board members must be more candid in demanding the information they need to achieve this insight and in probing further until they get the requisite clarity to do their job.

#### TIME, ATTENTION AND BOARD TURNOVER

It should be no surprise that the amount of time directors spend executing their duties has risen dramatically in the past two years. The average outside director spends 155.8 hours a year for each board on which he or she serves. They attend an average of 6.1 meetings per year, and 97 percent attend at least three-quarters of board meetings. Active CEOs sit on an average of 2.2 outside boards, and most directors believe in setting a limit of two or three outside boards on which a CEO may serve.

As a result of the added commitment required, board turnover has increased and the average number of boards on which directors sit has decreased. In tandem, more directors feel that board members are devoting the appropriate time and attention to their duties, up from 62 percent in 2001 to 72.9 percent in 2003.

There are no set requirements for the amount of time board members must devote to their responsibilities or the number of meetings they must attend. Yet we see directors increasing their level of commitment to serve their boards conscientiously.

#### CONCLUSION

By now, most company leaders have come to terms with the fact that corporate governance will never be the same. They've spent much of the past few years reviewing rules, policies and procedures presented by lawyers, accountants, consultants and other experts. Some have been put on the defensive by investors, the media and possibly even government inquiries. Under these conditions, it would be no surprise if boards fell into a rule-based, checklist mentality.

However, the current business climate also represents an opportunity for boards to look deeper into the fundamentals of the companies they serve. In fact, it should be a reminder for all professionals to take a fresh look at the companies we work at, work with and invest in, and hopefully come away with a new understanding of what is required to perform our duties with courage, candor and conscience.

