

THE CORPORATE GOVERNANCE ALLIANCE DIGEST

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Eleanor Bloxham, Editor-in-Chief

- In this issue: In the news, Eleanor Bloxham
- A conversation with former SEC chair Harold Williams, Eleanor Bloxham
- Interlocking directorates, powerful chairmen, tenuous commitment, Robert A.G. Monks, an excerpt from his new book, *Citizens DisUnited*, published by Minerva Press (<http://www.governmentcapture.com/citizens-disunited/>).
- Corporate governance of human capital—what the board should demand, Mark Ubelhart

In The News

By Eleanor Bloxham

This proxy season, it's all about the chair: who gets it, who gets to keep it and whether the chair is independent and good for the firm. After 18 years of holding the spot, Hess CEO John Hess is stepping down as chair. Disney shareholders showed strong but not majority support for a separate independent chair. Former Occidental CEO Ray Irani lost his board seat and chair position. And HP board member Ray Lane stepped down as chair. Will we see other changes at the top?

The CEO as chair is not a good idea and never has been. And more boards are starting to recognize the keys to the future include solid chair succession plans and chair evaluation processes that match the times.

It's true a bad chair can cause problems and an independent chair is not a panacea. But the solution is not to throw the baby out with the bathwater and give the CEO the reins.

The solution is to pick the right chair, an independent one, and hold that chair accountable. Who does that? The independent members of the board.

Former SEC chief Harold Williams championed the idea of the independent chair many years ago. Below, he and I discuss the state of boards and other topics.

http://en.wikipedia.org/wiki/Harold_M._Williams

Also below, we present an excerpt from Robert A.G. Monk's new book, *Citizens DisUnited*, published by Minerva Press (<http://www.governmentcapture.com/citizens-disunited/>).

<http://www.ragm.com/Extended-Biography.htm>

And below that you'll find an article discussing the importance of humans in the human enterprise of business written by Mark Ubelhart.

A Conversation With Harold Williams, Former SEC Chief (edited), By Eleanor Bloxham

EB: What are your thoughts on the auditing profession today?

HW: I'm not comfortable we have the level of independence we need. [There's an] overwhelming presence of the Big 4. We need stronger oversight.

EB: What is your view of the proposal for mandatory rotation of external audit firms?

HW: I'm not convinced that rotation of audit firms will solve the problem, although it's better than just rotation of partners.

EB: What is your view of the state of boards today?

HW: I have no reason to believe it's improved. There are no specific measures that show improved performance.

EB: What's your impression of the current SEC?

HW: My feeling generally is that the SEC is not being as aggressive as it ought to be, not as enforcement minded. It's an unfortunate impression. If it's erroneous, they must dispute it, but I'm not sure they can.

EB: What about the revolving door?

HW: The door has revolved for a long time, but when you tie that to a sense that the Commission is not aggressive enough in enforcing its mandate, that's serious.

EB: Why is that serious?

HW: It reinforces the idea that the SEC is not aggressive. It compounds the existing perception.

EB: What are your thoughts on the aftermath of the financial crisis?

HW: Too big to fail is scaring regulators from regulating. The concern is that if they push too hard they may create problems. At the SEC, the question is whether there's enough sophistication at the agency to deal with what's going on today.

EB: Sophistication?

HW: Yes, in hindsight, did they really know what was going on in the derivatives market? I'm not sure there's enough sophistication in the private sector to do what they were doing.

EB: What's the solution?

HW: The Volcker rule would help a lot. Banks should get out of the speculative business and back to what banks should be about. They would be dull at that

point but that's what we expect. No one should be dancing – that's the answer to Chuck Prince. [former CEO of Citigroup who said, "As long as the music is playing, you've got to get up and dance."]

You have to look at the structure of compensation. You will get the performance you reward – so don't be surprised. They were running faster when they should have been reining it in.

EB: Which brings us back to boards.

HW: Yes. It's hard for boards to stop the speculative stuff. It takes something bigger than boards. Boards don't want to get stuck. Investors don't want to miss the run up.

With the Volcker rule, we need back up for the regulators so there are no loopholes. Will it be a sieve anyway? That's the ultimate question. Regulators need more cover. It should come from Congress and the White House but it doesn't.

EB: Why?

HW: It's hard to say. Part of it is the divisiveness that exists. It's more complex now and it goes back to uncertainty. No one wants to take the risk of puncturing the balloon so the balloon will get bigger and bigger until it blows itself up.

The question is how to make sure the potential risk to society is not born by society. The risks should be born by the investors. And even if at some point, the government has to step in, they should then wipe out the investors. They kind of did that with GM. Bank stocks are at a premium because they're too big to fail.

EB: Do you still support the separation of the CEO and chair, the idea you championed?

HW: Yes. It's important the directors feel independent and the agenda is set by an independent chair.

Interlocking Directorates, Powerful Chairmen, Tenuous Commitment

By Robert A.G. Monks, Co-founder,
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This article is an excerpt from chapter 6 of Robert A.G. Monks' new book, Citizens DisUnited, published by Minerva Press.

[\(http://www.governmentcapture.com/citizens-disunited/\)](http://www.governmentcapture.com/citizens-disunited/).

Boards are at their strongest when they merge expertise, fresh perspectives, and a willingness to speak out with the iron-clad obligation to best serve the interests of the shareholders who elected them. They are far worse when they do little more than reflect the will of a CEO/chairman who hand selects directors either because of ongoing peer-to-peer friendships or assumed entrée to the capital markets in New York and the marble portals of the nation's capital. And they are at their absolute worst when directors sit on one another's boards, and the directorates themselves begin to interlock and serve mutual corporate interests rather than the specific interests of shareholders of the individual entities.

These "worse" and "worst" situations are true to a remarkable degree of the intricate networks of director connections that revolve around all four of the largest U.S. banks: Wells Fargo, J.P. Morgan Chase, Citigroup, and Bank of America, drones every one. Over the past two decades ago, these four banks have been cobbled together out of 37 separate financial-related institutions. But the consolidation is inter-bank as well. JP Morgan Chase owns a 1.8 percent stake in Wells Fargo, a 1.82 percent stake in Citigroup, and a 2.09 percent stake in Bank of America. (BlackRock has a stake in all four banks greater than 2.5 percent.) Today, it's less the individual banks than the sector itself that is "too big to fail" since one bank failure has the potential to affect all four, hence the remnants of all 37, and hence *every one*. (1)

Externally, the boards of the four banks connect, via one or more shared directors, with 58 other companies. Wells Fargo's directors' network alone includes the boards of 21 other public companies of which at least a third are themselves drones. Two of these drone boards—Chevron and Target—share not

one but two individual directors. One is the current CEO of Wells Fargo, John Stumpf, who doubles as chairman of the Wells Fargo board. Not including Stumpf, seven of Wells Fargo's fifteen directors are themselves either current or former CEOs, including the chairman of the compensation committee that oversees Stumpf's pay.

The four boards are also closely tied to multiple presidential administrations, regulatory agencies, and advisory commissions. Collectively, they include two former Cabinet members, a former member of the Federal Reserve Board of Governors, an ex-chairwoman of the Board of the Federal Reserve Bank of San Francisco, a one-time chairman of the Federal Deposit Insurance Corporation, several ex-Cabinet undersecretaries, the president of the Rockefeller Foundation, a director of the W.K. Kellogg Foundation, and other luminaries, including Crandall Bowles, chairman of Springs Industries and the wife of former White House Chief of Staff Erskine Bowles, better known today for his key role in the [Simpson-Bowles Commission](#).(2)

Lay these sweeping board connections out in graphic form and the result is a thing of beauty—a banking industry with sinuous connections into virtually every element of the economy and its overseers and regulators. But the question has to be asked: Do these four monster drone banks with their exquisitely credentialed directorates serve their shareholders, their customers, their communities, and/or their nation more effectively than their 37 predecessor organizations did? On this score, the evidence is decidedly negative. All four played a central role in the subprime-mortgage debacle that brought the national economy to its knees. Two—Citigroup and BOA—had to be rescued by American taxpayers. JP Morgan was up to its ears in the Enron and WorldCom debacles of a decade ago. Much more recently, the bank acknowledged mortgage overcharges on the families of military personnel serving in Afghanistan. Wells Fargo, which benefited from federal bailout money in the wake of the financial crisis, has been under almost constant assault by various governmental agencies for false claims, alleged discrimination, etc.(3)

True, the job of a board isn't to wade too far into the weeds of management, but

directors are charged with assuring the right CEO is in place and setting the right tone, and the level of malfeasance and extraordinary ineptitude displayed by the four banks cited above hardly can amount to a passing grade.

(1) Ric Marshall, "[Passive Investing and Indexed Companies](#)," GovernmentCapture.com, (accessed February 15, 2013).

(2) *Ibid.*

(3) Tamara Keith, "[Bank Overcharged Military Families on Mortgages](#)," NPR, January 19, 2011, and Shayndi Raice and Nick Timiraos, "[U.S. Sues Wells Fargo for Faulty Mortgages](#)," *Wall Street Journal*, October 10, 2012.

Corporate Governance of Human Capital—What the Board Should Demand

By Mark Ubelhart, Metrics and Measurement Consultant for KnowledgeAdvisors and former Practice Leader for Corporate Finance/Executive Compensation and Human Capital Foresight at AON Hewitt, markubelhart@global-analytics.com

Crises dominate the news. Fallible, untrustworthy, and misinformed people—however well intentioned—are at the heart of the matter. Board members should demand they have the information they need in all spheres. None are more important than human capital.

1. *Know how talent is attracted and retained.* Understand how the company attracts and retains those considered pivotal to the success of the company, regardless of position level. Mandate reporting to that end.

2. *Take advantage of the people data.* Understand how talent reporting systems and the impacts of learning programs are used. Ask "How has the company differentiated itself by using data insights to manage human capital?"

- Does the company create metrics that matter, connect them to business results, to use for accountability and incentive compensation?

- Does data provide reasonable predictions of the probability of losing key employees? Have we identified and managed the elements that contribute to retention risk?

Data includes employee surveys—and analytics to predict career success, promote ability, fitness to role, and retention risk. This data can be used to pinpoint management and recruiting programs that make a real difference.

3. *Standardize cross-company and over-time comparisons.* One statistic made available by Aon Hewitt is retention of what it calls pivotal employees. The standardized definition of pivotal employees is those having top quartile percentage pay progression within the company (adjusted for age, pay, and tenure). These are the employees the company is investing in, but not necessarily those adding the most value. However, in discussions with companies, this was the only standardized definition that emerged. If a company uses a standardized measure, it can then measure its ability to retain these employees relative to other companies, and one business unit relative to another.

The board and shareholders should care about this metric – and advocate its disclosure in the same way disclosures are made on other aspects of executive compensation today. The board should demand such reporting and Institutional Shareholder Services (ISS) should seek the same disclosure and discussion.

Why? Not surprisingly, research has demonstrated that greater success at retaining pivotal employees leads to improved financial results, after adjusting for reverse causality—that is, the propensity for improved financial results to lead to greater success at retaining such people. (See *The Valuation Handbook: Valuation Techniques from Today's Top Practitioners*" Wiley Finance chapter 19 "The Economic Impact on Firm Performance and Value of the Investment in Human Capital.")

Such internal reporting fosters more insight and discipline at the top and more accountability throughout. The Society for Human Resource Management (SHRM) and the Sustainable Accounting Standards Board (SASB) are both involved in pursuing standardized human capital reporting and disclosure. Both deserve constructive critique and support that recognizes the inherent risks and difficulties.

4. *Learn from the best value measurement techniques.* While sophisticated equity analysts may use the most vanguard financial metrics—such as Cash Flow Return on Investment (CFROI) and Economic Value Added or Economic Profit (EP), these same metrics are rarely used for internal management reporting because of perceived complexity. But the focus on a single metric is appealing—especially considering the typical deluge of human capital metrics companies use. The demonstrated linkage of these sophisticated metrics gives them special credibility. And their power comes when they are implemented in decision making, internal training, and incentive compensation.

The Board can and should strive for the same posture in human capital reporting—that is, use of shareholder-value-based human capital metrics, reinforced by internal processes and systems of communications. The non-profit Center for Talent Reporting is advancing a framework labeled TDRp (Talent Development Reporting Principles) to organize talent information like financial statement information, but in a simple easy to use manner. Others are using more complex methodologies to link talent attributes to shareholder value. This continues to be an evolving area, but clearly existing reporting is woefully inadequate.

5. *Identify and "fix" misaligned incentive compensation.* Excessive short-term focus where the inherent risks haven't had sufficient time to manifest themselves have led to "claw back" provisions. But there are better approaches. One example is an incentive plan for all employees

adopted by a major food company's research group that used a ten-year time horizon.

- During the first three years, the participants were credited (but not paid) a percentage of the revenue generated by their new products coincident with market entry.
- The next three years they received a larger percentage of the profit as these products achieved profitability; and
- The final four years they received an even larger percentage of the Economic Profit, profit after a return on capital had been subtracted.

This plan set a precedent that encouraged innovation and created great value for the company and these employees. Boards should advocate the search for opportunities like this to improve incentive design.

6. *Measure and monitor human capital "portfolio risk."* Boards of directors need to ensure risk mitigation plans (associated with losing employees) are implemented. Besides noting the number of employees at risk (a headcount metric), risk tracking should include the "investment" in them represented by their compensation. Management should disclose to the board the human capital portfolio risk measured in dollars; this provides a financial perspective that is part of an overall view of financial risk.

Disclosure—internal and external—is exceptionally powerful. It's time for boards to begin. Boards deserve and should demand disclosure of broad-based human capital information.

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