

### ***Should Investors be given Proxy Access and other governance rights?***

Everyone knows that the way a question is posed, frames the way the question is answered. In the world of Corporate Governance we are facing many critical issues but the way the debate is being framed we seem to fall short of addressing the real issues and truly solve the problem.

The debate over shareholder access is not new; it has been going on for years. It has risen beyond academic and governance circles and now it is dominating the public forum.

The SEC will most assuredly change the rules giving shareholders greater access to the proxy and other mechanism to further assert their influence. At this point I don't think we can change that.

This will surely change the makeup and culture in the corporate boardroom. But will this be for the better? I think if we reframe the issue being debated we will discover it is likely to create more issues than it solves.

By framing the issue as whether shareholders should have a greater say in the affairs of the company reduces the answer to an either/or solution; you either argue vehemently for shareholder rights or you argue just as forcibly against shareholder involvement. But the real issue, the one that rarely gets discussed, is what are we trying to achieve with greater shareholder involvement?

What is the objective of greater shareholder involvement? At the core, it is argued that shareholders are the true owners of the company and as owners they should have a significant say in the affairs of the company. On the surface I find it hard to argue with this objective; the owners of a company absolutely have a right to have a say on its direction! However as I look deeper this position is based on certain assumptions that I don't think hold true.

The first assumption is that shareholders are "owners" of the company –but are all shareholders owners?

The days when shareholders thought and acted like owners are long gone. Most shareholders are merely holders of stock certificates that they purchased with only one objective, to realize a return on their investment. I am not against investors achieving a return on their investment, far from it. But there are two ways to make money on investment. The first is to invest it to help the company realize its inherent potential. The second is to "play the market" which is akin to gambling. The first are value investors like Warren Buffett who seek to use their money to better the company and in return reap the benefits. The second are the vast majority of investors who have little or no knowledge of the firms they are investing in and only care about "picking the winners." For most investors the company is a means to an end and the company's welfare is of little importance except as a vehicle for increasing the size of their stack of chips.

A second assumption is that the realization of return on investment is consistent with the long term well being of the company. This is true in only a limited number of cases. It is much easier to financial engineer your way to profits that it is to improve the performance of a company. Objective observation

of recent economic troubles clearly shows the dangers of putting purely financial return at the center of decision making.

The final assumption is that it is management and the boards of these companies have been the cause of our recent problems. We seem, as a society to be blaming management and boards for their failure to better guide their companies away from the icebergs that have brought down the largest ships of our economy. And we blame the compensation packages and the greed of these executives as the cause of their bad decisions. But was it personal greed or was it simply their response to the imperative of building shareholder value?

Can you imagine a CEO, of a financial institution or any board member, standing up at an annual shareholder meeting in 2006, 2007 or even the summer of 2008 and declare they were not going to participate in the housing markets or the sub-prime markets. That they were not going to provide their investors with the same type of returns that other firms were providing. Can you hear the standing ovation – or is that the sound of activist investors calling for a new board and CEO?

And now we want to give more control to these investors based on the assumption that they are owners and know what is best for the companies they own. Did I just hear “let’s put the fox in charge of guarding the hen house?” Is that the type of response we would come up with if we asked more probing questions and framed the debate differently?

The first questions we must ask is what is a company and why does it exist. To some a company is nothing more than a lifeless object to be used towards the fulfillment of their personal ends. Most of our society operate within this framework, yet almost every CEO, company founder and director recognizes, at some level, that an organization is a living entity; a living entity with the ability, even the destiny, to realize its potential. Its purpose, its soulful purpose is to maximize the value it brings to the market place it serves through its goods and services.

I contend that viewing a company as a living entity whose reason for existence is to grow and realize its potential bringing value to society, creates a new framework by which to ask and answer the key questions of effective corporate governance.

Financial metrics such as ROI has been for many years the dominant metrics used to determine success. But setting financial goals as the dominant measure of success will lead to decisions and behaviors that are not in the interest of the company or society. And we are painfully experiencing the results of decisions in pursuit of financial gains; decisions that include increasing the risk exposure of the firm, bringing it to the brink of disaster and even complete collapse. Clever financial engineering can bring huge financial results for the short term. Sustainable results can only occur by a balanced exchange of money for value between the market and the firm.

This is not to say that financial returns should be ignored, quite the contrary. The realization of a return on investment is an extremely important metric indicating how well the firm is achieving its goal of serving the marketplace. Yet it is, at the end of the day, just a metric, not the goal.

When the focus is on the metric, it is easy to engineer a way to make the metric look good and even cover up the real performance of the organization in realizing its objective. Thus whoever is chartered

with the responsibility of guiding the firm must have as their core focus maximizing the firm's probability of achieving its potential, thus creating value to society. If this is the guiding principal of corporate governance then the other questions must be answered within this context.

We have already discussed that not all shareholders have the same orientation. In framing the issue of who directors should be accountable to, we must rely on our guiding principles – investors who are investing to help a firm unleash its potential are the investors directors should be accountable to. On the other hand directors should shield and protect the firm from those investors who are interested *only* in a financial return.

Admittedly the two are not mutually exclusive – financial returns are indicators of value perceived by the market it serves. However, without the balance of value contribution to a market, focusing dominantly on financial returns will lead to the type of behaviors we are trying to correct.

Within the new proposed proxy access rules, there is an attempt to recognize there is a difference in the investment community and that investors are not all alike. What is not clear is whether the criteria being proposed differentiate for the right things. The criteria of size of holdings or term of holding do attempt to differentiate investors; I fear it does not go directly to the core issue of discerning intention and motivation.

I recognize there is no easy and simple way to differentiate at this level it is my hope and desire that by reframing the issues and asking different questions we as a society will find a more effective solution that serves the firm as well as its investors.

And I firmly believe that in the end the solution lies best with strengthening the role of the directors not reducing it. I believe a key role of the director is to act as this guardian and to sort through the interests of all parties and resolve them in the best interests of the company's ability to realize its potential.

For almost three decades now, since 1981, the major focus of the board and of was framed within in the context of maximizing shareholder value. (A mantra that was stimulated in a speech by Jack Welch, then CEO of GE; a mantra he recently recounted, calling it the "dumbest idea" of all time).

If we check Delaware law and even California law, the statues read a directors responsibility is to the *COMPANY* and its shareholders (emphasis is mine). This I believe is in line with what I have suggested as the foundational context outlined above.

A director's responsibility is to the company, to ensure the company has a strategic direction that will convert its potential into actual delivery of value to the market. In doing so, the firm realizes a larger share of the market and the metric of Return is high thus fulfilling the second part of a director's duty, taking care of the shareholder.

Recognizing that not all forces operating on the firm are equally concerned with the welfare of the firm, someone, or group of people, must be charged with sorting out those forces that help a firm realize its potential and those forces that hinder it from doing so. Some of those forces come from the investor community as we have just indicated; some come from management, and some come from society at large such as special interest groups.

I believe it is the board and each director that must hold this as their primary responsibility; to decide ultimately what is in the best interest of the living entity they are chartered to watch over.

We actually have a model framework from our existing legal system that we can apply to this context. In family law when there is a dispute over custody, the court will often appoint a lawyer to look out for the best interest of the child.

A company is a legal entity in the eyes of the law with many of the same rights as individuals. Perhaps we can extrapolate that a prime role of the board is to be the custodian who is looking out for the best interests of the living entity we call a corporation. The key role of directors is to put the interest of the company above all other interests; discerning which inputs will enhance and further the realization of a firm's potential and hence its sustainable value and which are detracting from this objective. We are, at the end of the day, the "court appointed attorney" that is to be the objective arbiter of what is in the best interest of "the child."

Over the last decade I have seen many changes in the world of corporate governance. Starting in 2001 we had the introduction of Sarbanes-Oxley then the introduction of the CD&A and now today's proposed access proxy rules. While there has been much discussion about how awful these changes have been, some of which I agree with, I also believe at a deeper context level they brought a lot of good.

SOX shifted the center of power from management to the board raising the board's awareness of its role to a new level of custodian of the firm's well being and not just management's advisors. The CD&A heralded the need for greater transparency, which is also proving to be a positive impact, though poorly implemented. And there is potentially a lot of good that will come from the proper application of new proxy rules.

I completely agree that boards should be accountable for their actions. As individual humans, we are not immune to the pull of our own agendas. Being held accountable reminds us of our responsibility to be that objective arbiter for the living organization we are meant to serve.

My concern is that the current framing of the debate will cause the same set of unintended consequences that SOX and the CD&A have brought with it; the worst of which regarding proxy access would be to neuter boards and bring the fox in to guard the hen house.

If we can reframe the debate, if we can agree on some foundational premises and build from there, and if we can commit to finding the right solutions not just the easiest or those that come quickest to mind, then we can build a corporate governance structure in this country that will increase the growth and contribution of the firms we are called to serve.

And just imagine the contribution each firm we serve will make to society if it realizes its individual potential, and then extrapolate that to the total increase in overall value of our society. By reframing these issues, asking the right questions and setting the right framework we will directly impact the growth, well-being and value of our country.