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Now is the Time to Set A New Standard for Corporate Governance

By Connecticut State Treasurer Denise L. Nappier

Over the past few weeks, the media have been full of stories highlighting the problems at Merrill Lynch and Citigroup that led to the departures of their CEOs Stanley O'Neal and Charles Prince, respectively. The "problems" have been ascribed to fall out of the sub-prime loan crisis, but belie the real issue: Corporate Governance. This is the important story at Merrill Lynch, Citigroup and others that we must finally learn from, lest we are doomed to repeat it when the next issue emerges in the capital markets.

Since 1999, when I became Connecticut State Treasurer, I have joined with many other institutional investors in championing reforms in corporate governance. Some of these reforms have been achieved, and others are being actively considered by the Securities and Exchange Commission (SEC), in the U.S. Congress, among institutional investors and in corporate boardrooms. But we need to move beyond discussion to action and fundamentally change how corporations are run.

The sub-prime crisis was for financial institutions a problem created by the quest for short-term profits fueled by a lack of real board independence from management and perverse compensation agreements that rewarded imprudent behavior at the expense of a measured approach. So, here we are again. This time it's extreme unchecked risk taking, before it was excessive executive compensation not tied to performance, and before that it was back dating of stock options and the need to restate earnings; not to be outdone by the lack of independent audit committees. Ultimately, if companies are to be sustainable and deliver long term results to their investors, there must be an ongoing commitment to greater transparency and accountability to shareholders embodied by corporate governance.

We should start with a hard look at how corporate directors are chosen. Major long-term shareholders need to have a more direct input in the nomination of board candidates—a process now controlled by sitting directors, often with substantial influence by the CEO. Shareholders, corporate management leaders, regulators, and Congress have each taken a crack at reforming this broken process over the past six months, with little success. Boards are elected by shareholders to represent their interest, and it is high time that a reasonable process is put in place so that board members do indeed reflect those interests.

Executive compensation is another aspect of corporate governance that needs a major overhaul. For this reason, I have advocated more shareholder input on executive compensation through filing of and supporting "Say on Pay" resolutions, which are designed to give shareholders the ability to offer non-binding votes on executive

compensation packages. Ironically, during the last proxy-voting season, similar resolutions at Merrill Lynch and Citigroup received over 45% of the shareholder vote. Subsequently, in September of this year, a coalition of investors wrote to these two companies and others - urging them to adopt "Say on Pay" resolutions as part of good governance practice. However, neither company responded to our call, which led this month to Connecticut co-filing "Say on Pay" resolutions, once again at both companies, for the upcoming 2008 proxy season. We continue to encourage these companies to adopt "Say on Pay" because I agree with The New York Times columnist Paul Krugman who in a recent column called executive compensation that is wildly disproportionate to actual performance, "grossly unfair," and said it "encourages bad risk-taking, and sometimes fraud."

These most recent high-profile failures of management point out in numerous ways how ineffective SOME boards of directors have been when it comes to protecting the interests of shareholders. For example:

- At both companies, the directors were handpicked by the CEO, with no procedure in place for shareholders to nominate board candidates that would be responsive to shareholder interests. In both cases, the board gave the CEO too much latitude and not enough oversight until it was too late. Shareholders need board members who are elected because shareholders want them on the board – not because the CEO wants them on the board.

- Stanley O'Neal and Charles Prince both held the joint positions of CEO and chairman, which weakened the board's fundamental role of management oversight.

- At both Merrill Lynch and Citigroup there has been continued turnover in the management team, a fact which has weakened day-to-day operations and has led each company to continually look to the outside for leadership.

- Because of inflated executive pay and compensation, The Corporate Library—which rates companies on their corporate governance—gave both companies a failing grade. This is especially troubling, because the way board members handle executive compensation often signals how they oversee management on other issues. And these practices may be continuing; after all, Merrill Lynch gave new CEO John Thain a $50 million compensation package.

Make no mistake, every sophisticated investor understands and accepts the vagaries of the market. But the recent drop in the stock price at both Merrill Lynch and Citigroup were, in my view, less a function of the ups and downs of the market, and more directly related to the failure of both companies to have the appropriate checks and balances in place that could be achieved through real corporate governance reform.. Our failure to understand what is really at play here, and make the necessary changes, will condemn us to continually revisit these issues in the guise of a future and different "market correction".

Now is the time! In this season of good will and new beginnings, I call upon the heads of our country's corporations to set a new standard this proxy season by becoming allies with shareholders in making such corporate reforms the floor—rather than the ceiling—of good governance. Let's fill our stockings with resounding commitment in the New Year to approve shareholder access to the proxy; separate the offices of chairman of the board and CEO, and make the board chair independent; create a formal succession planning process at the board level in collaboration with the CEO; and, once and for all, enact responsible executive compensation practices - starting with "Say on Pay" and independence of the board's compensation consultant.