By Hye-Won Choi

Keys to Reform Over the Next 25 Years

"Corporate governance is more than declassifying boards or completing a social responsibility report—it is about making sure companies' governance processes address conflicts, align interests, and increase the likelihood of good decision making so that companies are able to reach their objective of maximizing long-term performance and shareholder value."

We are at a critical juncture in corporate governance in the United States. Many of the structural reforms that shareholders have asked for have been implemented. Many leading companies have adopted best practices such as majority voting in director elections. The Dodd-Frank legislation provides shareholders with additional rights including the advisory vote on compensation and proxy access. The reforms are a step in the right direction and an attempt to strengthen transparency and accountability but structural reforms are not enough to bring about better corporate governance. For markets to work well and be efficient, shareholders and companies must do their part to ensure that the goal of the reforms are achieved.

In my view, the primary goal of the reforms, whether it is the advisory vote on compensation or proxy access, is to encourage collaboration between companies and shareholders to develop private solutions to governance problems. Here are some ideas on how this can be achieved:

- There needs to be greater dialogue between companies and shareholders and a desire to develop private solutions to governance problems. Both shareholders and companies should recognize that it is in their mutual interest to seek common ground rather than be confrontational. Shareholders and companies should talk. The discussions could take a variety of forms, whether they are in-person or telephonic and could cover a range of governance policy issues in addition to financial and economic issues. We need to develop models that are flexible and yet meaningful and engender increased trust and understanding, leading to a better alignment of interests between companies and shareholders.
- These discussions should lead to the creation of market-based solutions to governance problems rather than more legislation, which can restrict flexibility if it is too prescriptive. Market-based solutions are the ideal and for this to happen, shareholders and companies must work together to develop solutions to governance concerns. However, private ordering cannot be successful if companies are reluctant to take on reforms for fear of being competitively disadvantaged.
- Companies need to change their way of thinking. Governance is not simply compliance items or box checking. Governance should not be interpreted as short-term measures or things that proxy advisory firms want but not shareholders. Governance should be integrated with strategy, performance, and goals. Corporate governance is more than declassifying boards or completing a social responsibility report – it is about making sure companies' governance processes address conflicts, align interests, and increase the likelihood of good decision making so that companies are able to reach their objective of maximizing long-term performance and shareholder value.
- Shareholders should understand that the goal of governance is not simply to vote every proxy but to enhance returns by reducing risk. Companies that do not have proper board oversight of management, do not have rational compensation policies aligned with shareholders, do not have effective controls of risk, and do not have a strong management team increase their investment risk. Good corporate governance is not a guarantee that companies will perform well but it certainly is a contributing factor. Shareholder policies and practices should be driven by the need to increase the long-term value of their holdings and generate good returns for underlying beneficiaries.
- Shareholders should also understand that it is the role of the board and management to run companies and should not try to micromanage or encroach upon the responsibilities of boards. Boards on the other hand should clearly articulate what they are trying to do with the company and the company's business strategy over the short- and long-term and then ensure management executes on the strategy.
- Executive compensation will continue to be an issue of concern for shareholders. Compensation decisions are a measure of the board's performance and independence. Compensation committees will need to clearly articulate the rationale and philosophy behind their decisions. Shareholders should respond by voting on the quality of the reasoning. Shareholders should evaluate whether the board has set policies that are long-term oriented, integrated with business strategy, and designed to drive value.

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- Succession planning and risk management will become greater priorities for companies. Boards must look ahead five to 10 years and set strategy and goals and identify the company's most significant challenges. Boards must make sure they have an executive team in place that can execute on strategy and ensure that financial incentives are aligned with meeting clearly articulated milestones without excessive risk-taking that could undermine the long-term sustainability of the company.
- Proxy advisory firms, while coming under greater scrutiny, will continue to provide the necessary service of providing recommendations on proxy decision-making. It should be recognized that such research is not developed in a vaccuum and reflects an amalgamation of the views of large institutions. Ulimately, however, the advisory firms provide only recommendations; the decisions are the responsibility of investors who should vote in alignment with their economic interests and should communicate their policies to companies and the market. The advisory firms also provide supplemental research used by shareholders to identify outlier companies to be included in governance initiatives and campaigns.
- Shareholders should ensure that their internal governance policies and practices are consistent with the policies that they advocate for the companies they own. They should make sure to properly address and manage conflicts and devote appropriate resources to proxy voting and governance analysis.
- Shareholders and companies should be more mindful of the need to integrate concerns about social responsibility into business planning. Socially responsible practices may help mitigate risk for corporations. For shareholders, reducing negative externalities, such as pollution, can help to mitigate portfolio risk as well. Companies should examine sustainability related risks, develop strategies to address them, and disclose the results of their deliberations.

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About the Author

Until September 2010, Hye-Won Choi served as senior vice president for corporate governance at TIAA-CREF. In 2009, she was appointed co-chair of the Securities and Exchange Commission's Investor Advisory Committee.