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Point/Counterpoint

HAVE WE PLACED TOO MUCH FAITH IN CORPORATE GOVERNANCE REFORM?

Across the globe, the trend toward corporate governance reform, increased governance legislation and more elaborate governance codes continues in response to the global financial crisis and to the opening of markets in developing economies. Advocates of these measures sometimes speak of them with missionary zeal, as though increased corporate governance is good by definition — and able to halt risk, corporate malfeasance and negative earnings reports by its mere implementation.

But through our work advising the boards of some of the world's leading companies, we encounter both high-performing companies that exhibit poor corporate governance and unsuccessful companies that embody every corporate governance best practice. Clearly, governance regulation plays a valuable role, but those who elevate its standing to that of corporate savior are exaggerating its power.

Embracing Basic Principles

There is no doubt that basic corporate governance guidelines have great value in helping to protect the interests of investors, particularly minority shareholders, and in aiding informed investment decisions. For these reasons, disclosure and transparency is integral when it comes to public companies' financial and operating results, company objectives, executive pay, board independence, major share ownership, shareholder voting rights, and governance structures and policies.

In a global business world where international investment becomes more widespread by the day, the adoption of these practices has become increasingly critical for public companies wishing to attract and reassure investors, and for investors seeking a degree of protection as they consider investment abroad. Therefore, the basic principles of corporate governance such as those proposed by the Organisation of Economic Co-Operation and Development and the United Nations Conference on Trade and Development should be a starting point for all public companies. Only global adoption of these principles can create a basic harmony of regulation that will allow shareholders to invest with confidence anywhere around the world.

Board Composition and Structure

Likewise, certain guidelines addressing the composition and structure of the board of directors can be considered general best practices for all listed companies around the world. For instance, to avoid conflicts of interest, it is generally advisable that a majority of directors and those of certain committees be independent. We would also view it as a best practice to appoint a lead, presiding or senior independent director to check the power of the chairman in unitary boards, particularly those where the CEO and chairman roles are combined.

But even these basic guidelines can sometimes fail to account for all the nuances of the real world. For instance, a 2009 study in the *Journal of Financial Economics* found that boards that had independent directors with social ties with the CEO correlated with higher executive compensation and lower CEO turnover after poor operating performance. This illuminates the fact that even established standards of independence do not account for all of the possible conflicts of interest that a board director may have, and can never truly guarantee director objectivity. At the same time, current independence requirements can also have the opposite effect of disqualifying some directors who may be able to provide both an objective perspective and invaluable industry and company experience that a true outsider may lack. This is especially true for industries in which directors need specialized technological or financial knowledge to contribute meaningfully to strategy discussions.

Independent directors, particularly those who complement the board's existing industry or geographical perspective, can provide fresh thinking and valuable contributions to the strategy discussions of the board. They can also help prevent majority shareholders from having undue influence. But legislation regulating the percentage of directors that must be independent often fails to account for the inherent differences in the talent challenges individual companies face and the very real contrasts between industries when it comes to the performance of industry outsiders as board members.

The Quota Question

Similar considerations should be weighed in viewing the relative merits of the gender quotas that have recently become law in several European nations. There is no doubting that talented women directors add value to boards. An oft-cited 2007 study by Catalyst found that Fortune 500 companies with the highest percentages of women board directors outperformed those with the least by 53 percent. This statistic is likely due, in part, to the diverse perspectives that these directors contribute, but also in part to the fact that the best companies are likely to have the most success in attracting qualified women directors.

Unfortunately, the current dearth of women in the boardroom is also mirrored in the senior executive ranks from which qualified board directors are typically drawn. Even in Norway, which pioneered quota legislation in 2003 by requiring public limited companies to fill 40 percent of board seats with women, just 10 percent of senior executives are women. Given that the percentage of women among retired executives is even lower, and that active executives tend to serve on far fewer boards today than they once did, we see intense competition for top female board talent today — even in countries with no quota legislation.

In our board recruitment work around the world, our clients highly value the diverse perspectives and insight that qualified women directors can bring. But they are also faced with the reality that adding women to the board sometimes requires the selection of directors who are more junior in rank and less seasoned in board experience than they would choose otherwise. In Norway, for instance, statistics show that the women who have been added to boards in response to the quota regulation are better educated, but also younger and less likely to have CEO experience, than the men they have replaced.

Though the addition of women directors contributes to deeper discussions and new perspectives on a board, companies are also taking a broader view of diversity as they thoughtfully strive to assemble boards that can provide a competitive advantage when it comes to company strategy. For instance, companies are eager to bolster their existing board talent with international executives who have experience in emerging markets, and with experts who add specific knowledge in areas such as social media.

This broader view of diversity — one that encompasses diversity of skills and knowledge, as well as gender — is most helpful in building boards that can create long-term shareholder value. For this reason, gender quotas should be viewed as a temporary means of addressing gender inequality in the boardrooms of countries that choose to adopt them, not as a template for effectively addressing the specific business needs and unique challenges of individual companies.

Regulating Board Effectiveness

Another area in which well-intentioned regulations can sometimes have unintended consequences is in requirements focused on improving board operations. For instance, there is considerable value in the idea that board directors should be trained, because there are many things about being on a board that first-time directors don't know. And, with continued enhancements to governance regulation, even seasoned directors are being charged with responsibilities in new and sometimes unfamiliar areas. As a result, requirements for board director training have become law in several jurisdictions.

But while the idea is good in principle, its implementation is often poor. When legislation without specific definition is passed requiring directors to get recurring training, it can spur a cottage industry of mediocre training companies, from which corporations may then select the lowest-cost provider who can help their directors meet the mandate most cheaply. And sometimes the actual content covered is so basic that many directors end up viewing the exercise as a waste of time.

Similar issues occur with board effectiveness reviews. When done well, these reviews are a tremendous asset in highlighting areas where there is room for improvement and greater efficiency. But codes requiring board effectiveness reviews can produce a box-checking approach, unless boards embrace the spirit of the assessments, rather than treat them as a compliance exercise.

A Blunt Instrument for Precision Work

By its very nature, corporate governance is a complex topic which must be viewed through many lenses. These include the dynamics and maturity stage of a company's market, the governmental environment it operates in, the maturity of the company itself, the unique demands of the company's industry, and the market for available talent at the board and senior executive levels, among other factors. As a result, there is no one truth about what makes good corporate governance, beyond the near-universal acceptance of the need for disclosure and transparency. These basics serve as a protective barrier for investors and business systems against the worst corporate governance practices, but still give companies the latitude they need to make decisions that are in the best interest of the company and its investors.

Beyond these basic principles, however, it may make the most sense for individual countries and exchanges to decide for themselves what level of regulation is most appropriate based on where they fall on the business life cycle. For instance, in economies with closed markets or a preponderance of family-owned corporations, we justifiably see less pressure to adopt governance regulation. As economies open up, they may require greater regulation as a temporary measure to ensure adoption of corporate governance best practices. And in more established market economies, an argument could be made for rolling back regulations once governance best practices become understood by companies and ingrained in their behavior. By its very nature, regulation is a blunt instrument that must be used with discretion.

When governance reform becomes too prescriptive in its specifics, it can prohibit companies from making the right decisions for each unique boardroom situation when it comes to complex questions such as whether to split the chair and CEO roles. For this reason, comply or explain approaches that give boards the latitude to make the right choices are often most helpful when regulation goes beyond the basic measures that ensure disclosure and shareholder protection.

The Real Key to Good Governance

Good corporate governance cannot ensure that a company has the right strategy to succeed — and too much focus on compliance issues can take too much of the board's attention away from its primary responsibilities. Most importantly, the jury is still out on the effectiveness of increased governance legislation, a fact that was reinforced when the epicenter of the financial crisis developed in the world's most regulated markets.

While some regulation is necessary and helpful, there is a danger in placing too much emphasis on it. When it comes to the boardroom, the most important considerations are, instead, assembling a board of executives who combine integrity with the right mix of knowledge, experience and vision to perform the board's defined roles with excellence. Beyond even these considerations, qualities such as judgment, engagement and strong communication skills are critical attributes for every director. And, just as it is a component in any high-functioning team, interpersonal chemistry also plays a role in every effective board. Wise decisions regarding board composition are complex, multifaceted and impossible to legislate. In the end, the true foundation for great governance can only be built by making these careful, thoughtful decisions in the service of a company's long-term needs and goals — not through governance reform.

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