




Corporate/Investor Summit Series

Revisiting Stock Market Short-Termism

RESEARCH REPORT



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ABOUT THIS **REPORT**

The Conference Board Global Corporate Governance Research Center held another in its series of Corporate/Investor Summits on July 6, 2005 in London. By convening some of the most distinguished representatives of the corporate and investment worlds, as well as other recognized experts in the field, the Summit explored the debate on market short-termism. The Summit was intended to serve as a first step in a renewed and more comprehensive look at the subject by Governance Center members.

This report represents a unique consensus achieved at the Summit. It addresses:

- The causative factors and the economic implications of a capital market system inclined towards short-termism.
- Why Summit delegates believe that now is the right time to search for concerted solutions to the distortions of short-termism.
- What The Conference Board Global Corporate Governance Research Center intends to do to foster the continuation of this debate and stimulate future actions by corporations, investors, and intermediaries to address the issue of short-termism.

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by Dr. Matteo Tonello

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ABOUT THE SUMMITS

Beginning in fall 2003, The Conference Board's Global Corporate Governance Research Center initiated a series of Corporate/Investor Summits convening major U.S. and UK corporations and investors to discuss issues of mutual concern. The goal of these summits is to develop a series of "best practices," followed by specific actions for both companies and investors to improve the way they communicate.

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The Issue of Stock Market

Short-Termism

The debate on stock market short-termism is long-running, dating back at least to the 1980s when a massive number of corporate takeovers occurred in the United States, often for “financial engineering” reasons rather than any strategic rationale. Japanese and German firms were then perceived to be better competitors than their U.S. counterparts because, it was widely argued, they planned and financed for the long-term, and were not subject to the takeover fever which permeated the United States into the early 1990s.

Disruptive events such as the bursting of the stock bubble in 2000 and the worldwide economic uncertainties of the last few years are raising new concerns about the lack of long-term vision on the part of corporations and investors. Excessive focus on quarterly results, scarce attention to value-creation strategies, and failure to probe deeply enough into long-term performance are believed to be leading to a kind of “short-termism” which damages market credibility and depresses today’s economic development. There was widespread consensus among Summit delegates on the need to address these issues and explore options to change the way the system works.

Undoubtedly, the health of an economic system depends on its ability to perform well year after year—not only during the next quarter. Where accompanied by a set of rules that assures equal treatment to all market participants, steady and sustainable growth becomes the key to prosperity for a society. Market short-termism, on the contrary, undermines confidence in the soundness of the underlying economy, favors opacity on strategic goals, and encourages opportunistic behaviors by a few to the detriment of the many.

A Concerted Effort to Adjust the System as a Whole Summit delegates concluded that short-termism is so embedded in the way the stock market functions that any attempt to tackle it piecemeal will fail. This is because “managers, analysts, and shareholders feel trapped in a short-term earnings game that none of them really likes, but all see no choice but to play.”¹

Summit delegates then agreed that aspects of the entire system must be adjusted *all at the same time* for there to be change—adjusting just one part of the system will be insufficient for meaningful change. For example, efforts by companies to improve communications on future strategic goals are often undermined by the resistance of financial analysts to properly value and take into account corporations’ long-term performance metrics. Similarly, the pressure exercised by organized investors so that management pursues sustainable growth opportunities may find an insurmountable obstacle in the system of incentives adopted by corporations to compensate senior executives for the results they deliver quarter by quarter.

For these reasons, numerous Summit delegates referred to short-termism as a “chain,” and welcomed proposals for concerted solutions involving not only the corporate link of the chain, but also those represented by the investment community and the so-called reputational intermediaries (such as securities analysts, external auditors and rating agencies).²

¹ Robert Eccles et al., *The Value Reporting Revolution: Moving Beyond the Earnings Game*, John Wiley & Sons, 2001, page 4.

² An argument about the need for a concerted and collective action by the securities industry components was made in Tomorrow’s Company’s June 2004 report entitled *Restoring Trust: Investment in the Twenty-First Century*, available at www.tomorrowcompany.com/publications.htm. The report follows two years of consultation with over 500 U.K.-based practitioners and interest groups representing all links of the investment chain. The report defines such a concerted action as a “helicopter view” of the system as a whole. Tomorrow’s Company is a business-led think tank based in London.

Causative Factors

In the 1970s, a series of events set the stage for the short-termism phenomenon that later emerged.

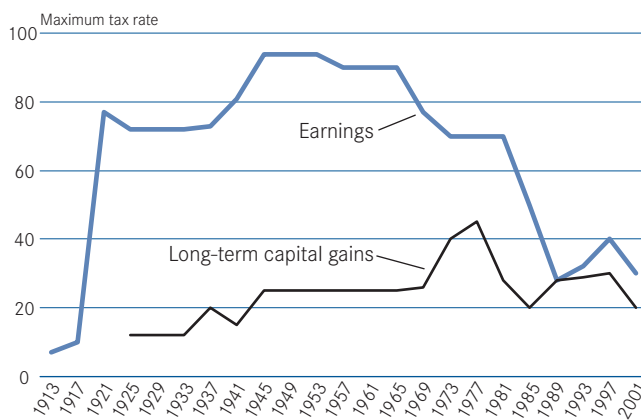
- Prior to the enactment of the Employee Retirement Income Security Act (ERISA) in 1974, the bulk of equities were held by individuals (especially wealthy investors). ERISA provided a framework of fiduciary assurance that enabled wealth to be accumulated in pension funds, forever changing the landscape of the capital markets in the United States and elsewhere.
- U.S. taxation policies fueled short-termism in several ways. First, prior to the early 1970s, the top rate for ordinary income was 75 percent, while the capital gains tax rate for investments held more than a year was only 25 percent. This meant that wealthy individuals could not afford to invest for the short-term because they would be taxed at the higher 75 percent marginal rate. With the top tax rate on ordinary income declining to as low as the current 35 percent³ and capital gains rates now at 15 percent,⁴ incentives to invest and hold equities based on the income and capital gains tax differential were substantially reduced (see Figure 1 for a comparison of income and capital gains taxation trends). Second, since pension funds were exempt from taxation, large pools of money enjoyed tax-exempt trading status. With no tax implications for their trading, and with beneficiary returns foremost in their minds, many pension fund fiduciaries yielded to short-term strategies and the higher profitability lure of the takeover premiums of the 1980s and 1990s.
- Market short-termism is also likely to have been influenced by Wall Street's move in the early 1970s from a fixed to a floating commission rate system for brokerage firms employing sell-side financial analysts. The new compensation structure resulted in considerable restructuring of Wall Street through mergers among the well-known brokerage houses that had supported in-depth research by a highly professional cadre of securities analysts. Many of these analysts were trained to pay close attention to the fact that a large pool of individual wealth was subject to the differential income and capital gains taxes then in place.

³ The top tax rate on ordinary income declined to 50 percent in the early 1980's, was further reduced to 28 percent in 1986, and then increased to the current level (35 percent) in the early 1990's.

⁴ The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) cut the top tax rate on long-term capital gains from 20 percent to 15 percent, the lowest level since World War II. JGTRRA also cut the rate on dividends to 15 percent; previously dividends had been taxed as ordinary income. Leonard Burman and Deborah Kobes, "Preferential Capital Gains Tax Rates," *Tax Notes*, Tax Policy Center, January 19, 2004.

Figure 1

A comparison of income and capital gains taxation trends



Note: Tax rates include the effects of implicit tax rates due to phase outs. Tax rates are those that apply to very high incomes. Taxpayers with lower incomes can sometimes be subject to higher effective tax rates due to phase outs.

Sources: Department of the Treasury, Office of Tax Analysis, July 2002, updated by authors

As a result, they engaged primarily in longer-term oriented “fundamental” security analysis of the type made popular by Benjamin Graham and David Dodd.⁵ However, the floating and then discounted commissions could not support these higher levels of fundamental analysis, resulting in a gradual shift to less in-depth and long-term focused research. In addition, some analysts were increasingly subject to pressures by their firms not to undermine more profitable financial service and trading business lines.

Delegates also discussed the reasons why—in the last two decades—the system has steadily moved toward short-termism. Three factors contributing to today's short-termism were identified.

The Corporate Culture Factor

The corporate scandals at Enron and WorldCom exposed stories of financial frauds, unnecessarily generous compensation schemes, lack of checks and balances, and other organizational inefficiencies in public companies that were being used by executives for their own personal—and often largely short-term—interest rather than to generate sustainable benefits to all stakeholders.

⁵ Benjamin Graham and David L. Dodd, *Security Analysis*, McGraw-Hill, New York and London, 1934.

To be sure, the excesses of the late 1990s have been curbed by the adoption of more stringent corporate governance standards:

- In the United States, this happened in the form of far-reaching mandatory legislation, such as the Sarbanes-Oxley Act of 2002 and subsequent SEC regulations.
- In the European Union, a series of recommendations passed by the European Commission in the context of its Action Plan on corporate governance established incentives to comply with “national” codes of corporate behavior (the major incentive resulting from the need to fully disclose to shareholders any departure from such codes).

Nevertheless, it is still too early to assess whether this series of reforms will translate into a strengthened ethics of doing business. In fact, as one Summit delegate observed, business ethics is just a component of personal ethics, which remains influenced by a variety of cultural factors and cannot simply be redefined by a new set of business rules. A corporate culture obfuscated by the leaders’ greed and ambition is therefore conducive to the distortions of capital market short-termism.

The Educational Factor

Traditionally, analysis of corporate performance involves rigorous employment of a fairly standardized methodology, resting primarily on an array of financial metrics. Such metrics are very effective in measuring monthly or quarterly results. They are, however, less helpful to assess the progress a company is making to achieve longer-term objectives, and need to be complemented by other (extra-financial) performance measures.

Credit and financial analysts receive a highly specialized education on quantitative financial evaluation methods, and are trained by their brokerage firms to become experts in the application of these methods to the industry (or industries) they cover. The development of their expertise is the result of years of hard work. Their resistance to change, therefore, is hardly surprising. To be effective, change needs to be encouraged at the educational level so that newly formed analysts are open-minded about alternative evaluation approaches, and willing to participate in the concerted effort necessary to revisit market short-termism.

The Speculative Factor

Institutional investors come in different breeds. Their objectives vary widely according to the institutions’ constituencies.⁶ Broad examples abound of investments, which are moved by speculative intents. Speculation is found not merely in the operation of hedge funds and in derivatives trading, but also in a large population of high-turnover portfolio managers ready to jump in and out of the market. Even some traditionally long-term pension funds now place at least a portion of their assets with high-turnover money managers or hedge funds.⁷ High turnover individuals and day traders have also entered the markets.

To some, financial speculation is an art. Certainly, it requires market savvy, a strong sense of timing, intuition, and a set of technologically advanced tools. Sitting and waiting for long-term growth is simply not contemplated in the strategies of those investors who are willing to take huge risks to enjoy multiple-digit capital appreciation. For them, the decision to buy or sell is made in a matter of minutes, or even seconds.

Summit delegates were unanimous in their belief that stock investment speculation is a major cause of market short-termism. Some blamed the rise of the hedge fund industry, which is speculative by definition. Others noted that hedge funds are a relatively recent phenomenon while speculation has existed for a long time, albeit in the more traditional form of actively managed high-growth mutual funds. All recognized that investment tactics based on speculative goals have been boosted by the market penetration of broad-band Internet and the availability of online brokerage services offering widely affordable access to real time quotes, stock news, charting, daily stock picks, and live technical analysis.

⁶ See the recently released data on institutional investments in the U.S. and abroad, in *The 2005 Institutional Investment Report: U.S. and International Trends* (by Carolyn K. Brancato and Stephan Rabimov), The Conference Board, R-1376-05-RR, September 2005.

⁷ For example, in a press release issued on March 29, 2004, U.K.-based Hermes Pensions Management announced that it is “substantially increasing its strategic commitment to incorporating absolute return into its investment strategy by allocating over £500 million for direct investment into hedge funds over the next 18 months on behalf of its owner and major client, the BT Pension Scheme.” Similarly, an expansion of the hedge fund program was approved in 2003 by the CalPERS Board of Administration, in an effort to increase returns and diversify its portfolio (see the February 18, 2003 press release, available at www.calpers.ca.org).

Economic Implications

According to a June 2004 survey jointly conducted by the U.S. National Bureau of Economic Research, Duke University, and the University of Washington, the majority of companies view financial indicators based on earnings (especially earnings-per-share or EPS) as key metrics of performance employed in the marketplace, more so than cash flow.⁸ As a result, most business managers stated that they would rather forgo an investment promising a positive return on capital than miss the quarterly earnings expectations of their analysts and financiers.

Short-term goals are volatile and affected by the sudden (and sometimes relatively minor) changes and fluctuations in the economic, political, and social environment. In the long run, this volatility can discourage management continuity and cause firms to lose sight of their strategic business model. A sound long-term strategy can act as a beacon to senior executives and boards of directors, permitting them to weather either natural economic downturns or temporary negative externalities.

Communicating leadership values to employees throughout the organization also becomes harder if the emphasis is on quarterly results and the direction followed by senior managers is continuously corrected to pursue new short-term objectives. Communication within a company is fundamental to align human resources and achieve strategic goals, but it requires time and persistence. Conflicting signals stemming from a variety of short-term objectives may generate confusion and discourage individuals. If the situation persists, the company may experience problems in retaining much needed intellectual capital.

Moreover, the pressure to meet short-term numbers may induce senior managers to search for a number of business costs (i.e. the cost of a state-of-the-art pollution

control system) to externalize, often to the detriment of the environment and future generations.

In addition, although empirical research has persuaded that R&D investment and growth opportunities are positively related to the use of employee stock options and other performance incentives by public corporations,⁹ distorted effects may result from compensation schemes unduly tied to short-term objectives. A broader horizon ensures that management remains committed to developing a robust and lasting business strategy. Instead, if the timeframe is limited, pressure on managers to vest their stock option grants “in the money” may induce them to inefficiently allocate an excessive amount of resources on short-lived ventures with a prospect for immediate results. Even worse, managers may manipulate performance numbers and disclose false or misleading financial information to stakeholders.

Finally, securities analysis focused on short-term results encourages retail investors to bet their savings on unsustainable business projects, and promotes a financial culture prone to the erroneous and dangerous idea that the stock market is a place to get rich quickly.

In conclusion, stock market short-termism negatively affects the economic system, as it does not provide proper incentives for businesses to pursue strategic opportunities that would translate into sustainable growth. Given the interrelations among economic systems in the current global marketplace, the deficiencies of one national economy may have immediate implications on another. Entrepreneurs, investors, employees, creditors, and other stakeholders in different parts of the world may ultimately suffer losses because of the growing tendency to short-termism of the major stock markets in the United States or the United Kingdom. Moreover, as markets are increasingly globalized, many of these same trends appear to be spreading to other industrialized countries.

⁸ John R. Graham, Campbell R. Harvey and Shiva Rojgopal, “The Economic Implications of Corporate Financial Reporting,” NBER Working Paper No. 10550, June 2004. On their part, most investment professionals recognize that discounted cash flow analysis (DCF), not earnings-per-share (EPS), is the appropriate model for valuing financial assets, including equities; but they believe that estimating distant cash flows is too time-consuming and costly to be efficiently employed in their investment decision-making process. This and other aspects of the economics of short-termism are eloquently explained by Alfred Rappaport, “The Economics of Short-Term Performance Obsession,” 61 *Financial Analysts Journal* 3 (2005), page 65-79.

⁹ See, for example, the PricewaterhouseCoopers’ white paper entitled *Employee Stock Options in the EU and the USA*, London, 2002; and Andrew Pendleton et al., “Theoretical Study on Stock Options in Small and Medium Enterprises,” Manchester, 2002. Both research projects were sponsored by the Enterprise-Directorate General of the European Commission. Also see Blasi et al., “Broad-Based Stock Options and Company Performance: What the Research Tells Us,” *Journal of Employee Ownership Law and Finance*, 3, 2000, page 69-102.

Why Now?

A number of reasons persuaded The Conference Board Global Corporate Governance Research Center that it is time to actively address the issue of short-termism. In fact, it appears that at no other time in the long debate have there been as many factors militating for change. These factors, detailed in the following six sections of this report, include:

- 1 Both the business and investors communities, now more than ever, recognize the need to restore investors' confidence and the credibility of the international capital markets, which have been undermined by the recent wave of corporate scandals.
- 2 Institutional investors, including large public and private pension funds and certain asset managers, have been taking unprecedented steps to monitor the management of their portfolio companies. They have done so by advocating accountability, the enforcement of shareholders' rights, and the adoption of higher standards of business integrity, as well as by investigating the possibility of directing assets towards investments with a greater long-term focus.
- 3 Institutional investors are now, more than ever, revisiting the "pay-for-performance" issue, and encouraging companies to devise compensation schemes based on a more balanced combination of financial and extra-financial indicators of performance.
- 4 There has been an unparalleled process of international convergence of accounting principles especially with regard to initiatives to design a new model of corporate reporting based on true value drivers and inclusive of extra-financial measures of performance (i.e. data on customer satisfaction and registered patents, indicators of employees' professional development, and other intangible assets used by businesses to pursue their strategic goals).
- 5 Certain major empirical research projects have recently reported results supporting the linkage between sustainability (i.e. environmental, social and corporate governance) factors and improved stock prices and shareholder value.
- 6 Regulators, intermediaries and institutional investors have undertaken unprecedented efforts to focus financial sell-side research on long-term corporate value. In addition, for the first time, a major group of institutional investors in the Enhanced Analytics Initiative have agreed to allocate a minimum of broker commissions to long-term securities analysis that effectively incorporates extra-financial measures of performance and corporate intangible measures of success.

A Business and Political Climate to Restore Confidence in the System

Confidence in the corporate and financial industries has been seriously eroded in recent years. What initially appeared to be a flaw in the American corporate model, soon acquired the characteristics of a worldwide phenomenon.

The bankruptcies of giants such as Enron and WorldCom are still making headlines as judicial sentences are being pronounced or settlements negotiated. Most important, they reopened the discussion on the key organizational problem of the modern public corporation, where the majority of ownership rights are held not by the individuals who manage the business but by a multitude of shareholders lacking the resources to directly oversee managers.¹⁰

Continental European companies have not been immune to scandals either. The events at Ahold, Vivendi, and Marconi are just a few examples of corporate debacles whose impact on national economies and public opinions was at least as strong as the consequences of Enron, WorldCom, and Global Crossing in the United States. The Parmalat case, in particular, uncovered similar failures of the European concentrated corporate

ownership system in monitoring senior management and strategic shareholders, and in ensuring the integrity of their behavior. The Italian dairy company collapsed spectacularly in 2003, amid massive frauds.

The Parmalat Case

Where Financial Engineering Prevails Over a Sound Long-Term Strategy

Italy's Parmalat is the most notable example of how managerial opacity and a lack of accountability can ultimately lead to financial disruption and failure, not only for defrauded retail investors, but also for the once-invulnerable controlling family. When the scandal broke, on December 19, 2003, Parmalat was already scoring low on the Institutional Shareholder Service's Global Corporate Governance Quotient. The company appeared at the very bottom of a list of 69 Italian companies rated by the proxy service provider, and was outperforming only 2.8 percent of businesses in the MSCI EAFE index (which comprises a variety of firms listed in major European and Asian exchanges).

Throughout the 1990s, Parmalat appeared to be a successful multi-national company, boasting an array of widely recognizable consumer brands as well as distribution channels in many parts of the globe. Below the surface, however, the company had abandoned a sound expansion strategy for an obscure and misleading financial scheme that preserved the controlling power of the founder's family. Fraudulent transactions at Parmalat were possible because of affiliations between directors and owners, independent board members' lack of expertise in finance and risk management, and corrupted entanglements with statutory auditors and the investment banks engaged by the company to place risky debt securities among retail investors. Through these and other shortcomings in the company's governance system, the controlling shareholder managed to hide its inability to face the new challenges of a competitive and globalizing market.

Source: Matteo Tonello, *Family Controlled Corporations: Defining Corporate Governance Best Practices to Add Firm Value*, The Conference Board, Executive Action Series No. 161, September 2005, page 7.

¹⁰ The problem of the separation of ownership and control was first identified over seventy years ago by Adolph Berle and Gardiner Means, *The Modern Corporation and Private Property*, New York, 1932. Until a few months before its demise (in December 2001), Enron was the seventh largest company in the United States, with operations extending worldwide. The literature analyzing how fraudulent events at Enron's determined its rapid collapse is vast; notable contributions include: Carolyn K. Brancato, "After Enron It's Back to Basic: 10 Questions Boards of Directors Need to Ask," The Conference Board Executive Action Report, A-0025-02-EA, June 2002; John C. Coffee, "Understanding Enron: It's About the Gatekeepers, Stupid," 57 *The Business Lawyer* 1403 (2002); Shang-Jin Wei and Heather Milkiewicz, "A Case of 'Enronitis': Opaque Self-Dealing and the Global Financial Effect," The Brookings Institution Policy Brief No. 118, April 2003; Douglas G. Baird and Robert K. Rasmussen, "Four (or Five) Easy Lessons From Enron," 55 *Vanderbilt Law Review* 1787 (2002); John R. Kroger, "Enron, Fraud and Securities Reform: An Enron Prosecutor's Perspective", 75 *University of Colorado Law Review* 4 (2004); William M. Bratton, "Enron and the Dark Side of Shareholder Value," 75 *Tulane Law Review* 1275 (2002); Lynne Dallas, "A Preliminary Inquiry into the Responsibility of Corporations and Their Directors and Officers for Corporate Climate: The Psychology of Enron's Demise," 35 *Rutgers Law Journal* 1 (2003).

Economic effects from the corporate scandals in the United States and abroad were exacerbated by other negative news from the geopolitical front (i.e. the terrorist attacks of September 11, 2001, disruptions in the Middle East and the prospect of a sharp rise in oil prices), and triggered a chain of highly negative market reactions. For months, investors fled the international stock markets, which suffered enormous losses. From the summer of 2001 to the spring of 2003, all major U.S. stock indexes tumbled; NASDAQ reported a one-third decline in capitalization in 2002, while the Dow Jones Industrial Average and the S&P 500 experienced the longest downturn since the Great Depression of 1939-1941. Overseas, at the beginning of 2003, Japan's Nikkei 225 was down over 20 percent, and Britain's FTSE 100 about 25 percent. Amidst increasing concerns among foreign investors on the health status of the U.S. markets, in the first half of 2002 the dollar-to-euro exchange ratio began its long-lasting downturn.

A cycle of shrinking consumption and economic output for many nations was accompanied by business failures and plummeting share prices which deprived millions of employees and shareholders of their lifetime savings and retirement benefits. In October 2002, The Conference Board Consumer Confidence Index for the United States (which had declined for four consecutive months) reached its lowest level since 1993.¹¹ A study conducted in the aftermath of the WorldCom bankruptcy petition, which was filed on July 21, 2002, estimated the aggregate first-year costs of the Enron and WorldCom scandals to the U.S. economy at \$35 billion, resulting in a 0.34 percent decline in the country's GDP.¹² In the fall

of 2002, poor economic performance was also detected abroad, as measured by The Conference Board's Leading Indexes for Spain, the U.K., Germany, and France.¹³

The need to correct the system and restore its credibility was so imperative that it fostered initiatives from all fronts (governments and legislatures, academic institutions, and associations of market participants).¹⁴ In the United States, Congress was the driving force behind the strengthening of the capital market regulatory regime and the effectiveness of its enforcement. A wave of enforcement actions—empowered by the additional resources the SEC received in connection with the enactment of the Sarbanes-Oxley Act—has supported the investigation of corporate malfeasance. Hundreds of executives have been barred from serving on corporate boards, and millions of dollars of improper financial gains are being returned to companies and shareholders.

In the European Union, recommended legislative changes take longer to implement, since they need to be ratified by authorities in each of the single member States. Nonetheless, significant efforts to effectively sanction responsible individuals and disgorge their unlawful profits have been made in the United Kingdom, France,

¹¹ The U.S. Consumer Confidence Index announced by The Conference Board on October 29, 2002 was 79.4 (1985=100), down from 93.7 in September 2002.

¹² See Carol Graham, Robert E. Litan and Sandip Sukhtankar, "Cooking the Books: The Cost to the Economy," The Brookings Institution Policy Brief No. 106, August 2002. The number is calculated using the Federal Reserve Board's model of the U.S. economy.

¹³ The following were the Leading Indexes published by The Conference Board in September 2002: Spain -0.4 percent; France -0.2 percent; Germany -0.3 percent. Calculated in August 2002, the Leading Index for the United Kingdom was -0.4 percent. In all cases, continued weakness in the stock market and lack of consumer confidence were enlisted as the major causes for the declines.

¹⁴ In 2002, The Conference Board established a 12-member Commission on Public Trust and Private Enterprise, whose mandate was to address the circumstances which led to the corporate scandals that were widely reported during 2001-2002 and the subsequent decline of confidence in companies, their leaders and American capital markets. The Commission was co-chaired by Peter G. Peterson, Chairman of The Blackstone Group, former Secretary of Commerce and Chairman of the Federal Reserve Bank of New York, and John W. Snow, Chairman, CSX Corporation and former Chairman, Business Roundtable. The Commission's Findings and Recommendations are available at www.conference-board.org/knowledge/governCommission.cfm.

The Netherlands, and Italy. In the specific case of Parmalat, its government-appointed administrator has established tens of legal proceedings—in Italy as well as before U.S. courts—to recoup million of euros from banks he believed helped prolong the previous management’s fraud. In addition, the company was brought public again in October 2005, as creditors voted to swap their astonishing debt-related claims of \$24 billion for equity in the new company.

Given the impact of the scandals of the last few years, the public sensitivity to the issues of a well-functioning and credible capital market is unprecedented in recent economic history. Summit delegates acknowledged that because of such sensitivity, the business community is now, more than ever, being called upon to re-examine its traditional strategies and, accordingly, may be ready to revisit and better appreciate the importance of a high-level discussion on short-termism.

Shareholder Activism Movement and Corporate Governance

Institutional investors can be the major advocate of long-term growth and sustainable corporate performance. Today, they have more clout in the boardrooms than ever before. Through the aggregation of resources and voting power of many smaller shareholders, the most influential institutions are in a position to promote positive enhancement of corporate governance mechanisms within the public companies in their portfolios.¹⁵

For example, large public pension funds (such as CalPERS and TIAA-CREF, in the United States, and Hermes and Universities Superannuation Scheme (USS) in Europe) have long-standing programs of corporate governance,¹⁶ which they believe have spearheaded meaningful change in a number of public corporations. Some changes came about through proxy contests and legal battles, while others resulted from the investors' pursuing of fruitful engagement with senior executives.

According to Summit participants, today there is more public recognition of the crucial role that may be played by large investors in promoting strategic long-termism. As Raj Thamotheram, Senior Adviser to Universities Superannuation Scheme (USS) put it, “previously those who might have raised concerns about market short-termism would have been dismissed as ideologically motivated critics. Yet there is now a growing acceptance among pension funds globally that their mission should be to optimize the long-term value of the fund and—of particular importance—that this mission should become the focus of a more informed and assertive approach to investment supply chain management. While long-term value optimization is far from being a new concept, what is new is that acting as if the long term is simply a collection of short terms is no longer considered a good enough approach. And related to this, it is increasingly unacceptable for a fund manager to seek to explain away loss on the basis that the risks were ‘hard to evaluate’ and ‘many others in the market missed it too.’”¹⁷

Specifically, institutional investors are in the position to seek a constructive dialogue with management and communicate their desire that the business be truly run in the long-term interest of shareholders. In fact, according to a business executive who attended the Summit, “corporations are more willing to listen, and understand that the involvement of their investors in the strategic decision making process is no longer an option; it is a necessity.”

¹⁵ For an overview of the events that marked the history of the shareholder activism movement in the United States, see Jay W. Eisenhofer and Michael J. Barry, *Shareholder Activism Handbook*, Aspen Publishers, 2005, pp. 3-1 to 3-74. The development of shareholder activism is traced from its origins, in the 1930s, to the present day. According to Eisenhofer and Barry, the origin of the activism movement may be found in the endeavors of Lewis Gilbert, who in the early 1930s encouraged corporations “to pursue non-financial objectives . . . , both because he felt it was good business in the long term and because . . . ‘owners’ need[ed] to be responsible members of the community, regardless of financial education” (p. 3-4). Also see Bernard S. Black, “Shareholder Activism and Corporate Governance in the United States,” *The New Palgrave Dictionary of Economics and the Law* (1998); and Carolyn K. Brancato, “Institutional Investors and Corporate America: Conflicts and Resolutions—An Overview of the Role of Institutional Investors in Capital Markets and Corporate Governance,” Hearing Before the Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs, United States Senate, 101st Congress, 1st Sess., p. 6 n. 1 (October 3, 1989). On the rise of the activism movement in Europe, see Fabrizio Barca and Marco Becht, ed., *The Control of Corporate Europe*, Oxford University Press, 2001. The role of institutional investors in the development of corporate governance standards is discussed, among others, by Roberta Romano, “Less is More: Making Shareholder Activism a Valued Mechanism of Corporate Governance,” 18 *Yale Journal on Regulation* 174-251.

¹⁶ For example, TIAA-CREF’s Policy Statement on Corporate Governance moves from the belief “that sound corporate governance contributes significantly to long-term corporate performance.” Accordingly, the trustees’ fiduciary responsibility to the fund’s participants is to “be advocates for better corporate governance – both as a means to improve long-term value . . . and to foster the investor confidence necessary for the long-term viability of the free market system” (2004, page 1).

¹⁷ Also see, for further discussions, the work published in the United Kingdom by The Marathon Club, a group of pension funds and large asset owners committed to identify innovation approaches to long-term investing: The Marathon Club, *Long-Term Long-Only Investing: A Consultation Paper*, March 2006.

The Rise of Institutional Investors

The accumulation of equity holdings by institutional investors in the last thirty years is documented in The Conference Board's *2005 Institutional Investment Report: U.S. and International Trends*.¹⁸ In the United States, Table 1 shows that the market value of total institutional equity holdings increased from about \$9 billion in 1950 to \$53 billion in 1960 (12.6 percent of total U.S. equity market), then to \$166 billion in 1970 (19.4 percent), to \$571 billion in 1980 (37.2 percent), to \$1.463 trillion in 1990 (41.4 percent), and to \$9.131 trillion in 2000 (51.8 percent).

Despite the market declines of the period 2000-2002 (during which total outstanding equity decreased at a faster rate than the holdings by institutions), institutional investors have regained much of their lost ground, both in terms of total assets and their equity ownership control in U.S. markets. According to the report, in 2003 institutional investors held \$19.634 trillion in assets and controlled \$7.974 trillion in equity (or 59.2 percent of outstanding equity in the United States).

This trend is paralleled at the international level. In Europe, in particular, countries are moving from debt to equity as a means of financing. OECD data in Table 2 depict the situation in the 10 countries with the largest institutional asset base, as well as European Union totals. Institutions in the 10-country group have been investing more heavily in equities (+11 percent), at the expense of bonds and loans. In countries such as the U.K., France, and The Netherlands, asset allocation in equities by institutional investors was in 2001 as high as 65 percent, 43 percent and 43 percent, respectively.

Summit delegates stressed that cooperation between the corporate and investor sectors, in particular, is a fundamental prerequisite to any attempt at addressing the issue of short-termism.

Over the course of time, developments in U.S. securities and investment rules have not only accommodated the growing presence of institutional investors in the equity marketplace,

Table 1
Institutional Investor Holdings of
Total Outstanding Equity, 1950–2003

Year	Market value of total outstanding equity (\$ billions)	Market value of total institutional equity holdings (\$ billions)	% Institutional equity
1950	142.7	8.7	6.1%
1960	421.2	52.9	12.6
1970	859.4	166.4	19.4
1980	1,534.7	571.2	37.2
1990	3,530.2	1,463.1	41.4
1995	8,345.4	4,070.3	48.8
1999	19,522.8	9,352.2	47.9
2000	17,627.0	9,131.3	51.8
2001	15,310.6	8,099.9	52.9
2002	11,870.9	6,597.1	55.6
2003	13,479.7	7,973.7	59.2

Source: The Conference Board Global Corporate Governance Research Center Values of total outstanding equity from The Board of Governors, The Federal Reserve System.

Both public (the most “activist”) and private pension funds together account for over 60 percent of institutional holdings in The Netherlands, for 47.2 percent in Australia, for 46.7 percent in Canada, for 44.6 percent in the United States, and for about 34 percent in the United Kingdom and Japan. By comparison, their role remains minimal in continental European countries (and virtually non-existent in France and Germany).

but also fostered their activism. Investor delegates to the Summit recalled some of the advancements in the U.S. regulatory regime allowing for improved communication between shareholders and management.

The Rule on Shareholder Proposals

Institutions have been empowered by changes in U.S. regulation of the proxy process, including the adoption of procedures to undertake an independent proxy solicitation and to enable shareholders to use the proxy statement to bring certain proposals before the

¹⁸ Carolyn K. Brancato and Stephan Rabimov, *The 2005 Institutional Investment Report: U.S. and International Trends*, The Conference Board, R-1376-05-RR, September 2005.

Table 2
Asset Allocation by Institutional Investors by Country

		U.S	Japan*	U.K.	France	Germany	Italy	Netherlands	Canada	Australia	Korea	10-country ** average
Equities	2001p	44%	16%	65%	43%	24%	18%	43%	25%	54%	6%	34%
	2000	49	17	65	46	28	23	43	27	53	7	36
	1999	51	19	68	42	28	22	45	27	50	11	36
	1996	42	17	68	25	14	12	28	27	46	12	29
	1993	33	22	70	22	12	11	21	23	41	12	27
	1992	30	22	68	19	10	9	16	21	42	14	25
Bonds	2001p	35	56	15	47	42	54	31	39	18	55	39
	2000	32	53	15	45	40	49	30	40	20	51	38
	1999	32	49	14	47	40	53	28	43	23	49	38
	1996	38	47	16	61	43	75	29	43	27	47	43
	1993	45	37	15	67	43	76	24	45	31	37	42
	1992	45	37	14	66	42	77	22	48	39	34	42
Loans	2001p	9	21	1	3	28	-	15	5	4	16	11
	2000	9	21	1	2	27	-	16	6	5	18	12
	1999	8	21	1	3	28	0.1	18	6	5	17	11
	1996	9	26	1	4	38	-	31	9	5	30	17
	1993	11	29	1	4	40	1.0	41	13	6	31	18
	1992	13	29	1	8	43	1	47	15	9	32	20
Other	2001p	11	7	19	7	6	27	11	11	24	23	15
	2000	10	9	19	7	5	28	11	10	22	25	15
	1999	10	11	17	9	5	24	9	9	22	23	14
	1996	11	10	16	10	5	13	12	9	22	23	13
	1993	11	12	15	7	5	12	14	9	22	19	13
	1992	12	12	16	8	4	13	15	7	10	20	12

* Excludes pension funds in 1992 ** Average not weighted by size of institutional assets p =Preliminary data

Source: The Conference Board, compiled from OECD data

annual general meeting. The number of proposals submitted under Exchange Act Rule 14a-8 has been rising steeply over the last few decades and reached a record 703 proposals during the 2004 proxy season.¹⁹ Shareholder proposals have become the tool preferred by institutional investors to encourage the discussion²⁰ of a variety of social, environmental, or corporate governance issues that are intimately connected with

the company's long-term strategy and crucial to the health of its business.²¹

¹⁹ See "2005 Postseason Report. Corporate Governance at a Crossroad," Institutional Shareholder Services, November 2005, available at www.issproxy.com. The number refers to the proposals that actually made it on the company ballots. Of those, 138 proposals won majority support in 2004.

²⁰ A proposal typically consists of a resolution and a supporting statement outlining the arguments in favor of the proposal that may be discussed at the meeting.

²¹ As the SEC put it, "Rule 14a-8 provides an opportunity for a shareholder owning a relatively small amount of a company's securities to have his or her proposal placed alongside management's proposals in that company's proxy materials for presentation to a vote at an annual or special meeting of shareholders. It has become increasingly popular because it provides an avenue for communication between shareholders and companies, as well as among shareholders themselves" (SEC Staff Legal Bulletin No. 14 (July 13, 2001), at § B(1)).

The Narrowed “Ordinary Business Operations” Exclusion

The SEC has regularly reexamined the circumstances under which corporate management may exclude a shareholder proposal on the ground that it “deals with a matter relating to the company’s ordinary business operations.”²² Notably, since the 1970s the SEC has been narrowing the interpretation of the exclusion and reasserting the position that shareholder proposals on business matters involving “any substantial policy or other considerations” would not be excludable.²³ As recently as December 2002, the Commission again made clear that a broad reading of the exclusion should not be used to inhibit shareholder proposals meant to protect the flow of accurate corporate information. Specifically, it announced that “in the future, it will not treat shareholder proposals requesting the expensing of stock options as relating to ordinary business matters,” as the restoration of shareholder confidence and of the integrity of financial reporting “all depend on shareholders’ rights to express to management their insistence that corporate income statements must be complete and accurate.”²⁴

The Facilitation of Other Forms of Communication among Shareholders

In the early 1990s, amendments to the SEC proxy rules were adopted to remove restrictions on the ability of investors to exchange information with each other. As a result of the changes, investors may, for example:

- Communicate privately among one another, in oral or written form; and even solicit a certain initiative, provided that they do not, “at any time during such solicitation seek directly or indirectly, either on [their] own or another’s behalf, the power to act as proxy for a security holder.”²⁵
- Publicly announce how they intend to vote on a particular matter and the reasons for doing so.²⁶

Because of these amendments, U.S.-based and international institutional investors holding shares in U.S. public companies can now freely raise issues of concern and

launch open forums of discussion. CalPERS Shareowner Forum, in particular, was specifically “designed to communicate with [its] fellow market participants CalPERS’ governance actions that are relevant to upcoming voting decisions.”²⁷

The financial press and a raft of shareholder organizations often do the rest, disseminating awareness about the issues and completing the process of communication to the public at large. In fact, “the threat of public exposure is an important part of CalPERS’ approach.”²⁸ Ultimately, an extensive number of small stakeholders might be engaged in the debate on the merit of a corporate decision that would otherwise not have been brought to their attention.

The Expanding Scope of the Definition of Fiduciary Duty in Investment Management

Shareholder activism in the United States was also fueled by the Department of Labor (DOL), which has consistently encouraged fiduciaries of pension plans to communicate and closely monitor the management of the corporations they invest in. In fact, standards set by the DOL for employee benefit plans represented the basis for the more recent revision of SEC rules on proxy voting by mutual fund managers and investment advisers.

²² Rule 14a-8(i)(7) under the Securities Exchange Act of 1934.

²³ SEC Release No. 34-12599 (November 22, 1976).

²⁴ SEC No-Action Letter, *National Semiconductor Corp.* (December 6, 2002).

²⁵ Exchange Act Rule 14a-2(b)(1).

²⁶ Exchange Act Rule 14a-1(l)(2). The rule is only applicable to the communication that:

“(A) Is made by means of speeches in public forums, press releases, published or broadcast opinions, statements, or advertisements appearing in a broadcast media, or newspaper, magazine or other bona fide publication disseminated on a regular basis,

(B) Is directed to persons to whom the security holder owes a fiduciary duty in connection with the voting of securities of a registrant held by the security holder, or

(C) Is made in response to unsolicited requests for additional information with respect to a prior [similar] communication by the security holder ...” (paragraph (iv)).

²⁷ CalPERS Shareowner Forum is available at <http://www.calpers-governance.org/forumhome.asp>.

²⁸ See Alexander Dyck and Luigi Zingales, “The Corporate Governance Role of the Media,” in R. Islam ed., *The Right to Tell: The Role of Mass Media in Economic Development*, The World Bank, Washington DC, 2002: “CalPERS found that when it removed this publicity threat its strategy did not work. In 1992, when several chief executive officers ... convinced CalPERS that a ‘kinder, gentler’ strategy would be less antagonistic and more effective, only 2 of the 12 targeted companies negotiated acceptable agreements with CalPERS and 3 resisted even meeting with CalPERS officials.”

ERISA Section 404(a) says employee benefit plan fiduciaries “must discharge their duties with respect to the plan solely in the interest of the participants and beneficiaries,” acting “with the care, skill, prudence and diligence under the prevailing circumstances that a prudent person acting in a like capacity and familiar with such matters would use.” The responsibility for selecting an investment carries with it the duty to monitor the portfolio over time and ensure that it continues to meet the exclusive interest of beneficiaries. Exercising voting rights so as to compel changes when they appear necessary to long-term objectives of future retirees is, therefore, a fundamental component of the trustees’ duties. Hence, the DOL’s requirement to disclose proxy voting records to plan participants.

An Interpretative Bulletin issued by the U.S. DOL in 1994²⁹ stated: “the fiduciary obligations of prudence and loyalty to plan participants and beneficiaries require the responsible fiduciary to vote proxies on issues that may affect the value of the plan’s investment” and “that the named fiduciary appointing an investment manager periodically monitor the activities of the investment manager with respect to the management of plan assets, including decisions made and actions taken by the investment manager with regard to proxy voting decisions.”

The Department of Labor has crafted a definition of shareholder activism by stating that: “an investment policy that contemplates activities intended to monitor or influence the management of corporations in which the plan owns stock is consistent with a fiduciary’s obligations under ERISA where the responsible fiduciary concludes that there is a reasonable expectation that such monitoring or communication with management, by the plan alone or together with other shareholders, is likely to enhance the value of the plan’s investment in the corporation, after taking into account the costs involved. *Such a reasonable expectation may exist in various circumstances, for example, where plan investments in corporate stock are held as long-term investments or where a plan may not be able to easily dispose such an investment.*”³⁰

In addition to exercising the legal rights of a shareholder, “active monitoring and communication may be carried out through a variety of methods including by means of correspondence and meetings with corporate management.”³¹ “What is needed are ways of devising a constructive dialogue with management and, most importantly, of assuring active, independent boards of directors who audit and *review not only short-term corporate financial performance, but all those factors which indicate how the corporation will perform over the long run.*”³²

Similar fiduciary standards are now applicable to any management investment company subject to SEC registration under the Investment Company Act of 1940 as well as any investment advisor subject to the Investment Advisory Act of 1940. According to a new set of rules adopted by the SEC in January 2003, an investment fund holding publicly traded securities or an investment adviser that exercises voting authority over client proxies is required:

- to adopt policies and procedures reasonably designed to ensure that the investment manager or the adviser votes proxies in the best interests of clients;
- to disclose to clients information about those policies and procedures; and
- to maintain and make available to shareholders and clients certain records related to the specific proxy votes that they cast in shareholder meetings.³³

In one of the accompanying releases, the SEC stated that “requiring greater transparency of proxy voting by funds may encourage funds *to become more engaged in corporate*

²⁹ DOL Interpretative Bulletin Relating to Written Statement of Investment Policy, Including Proxy Voting Policy or Guidelines, 59 Fed. Reg. 38863, 29 C.F.R. § 2509.94-2 (July 29, 1994).

³⁰ *Id.* Emphasis added.

³¹ *Id.* Pension funds, in particular, have also had active roles in corporate and securities legal proceedings, serving, in certain cases, as class action lead plaintiffs (i.e. CalSTRS in Homestore.com 2002 lawsuit) or as members of committees representing securities holders of bankrupt corporations (i.e. CalPERS and Pennsylvania Public School Employees’ Retirement System in the 1987 Texaco bankruptcy).

³² Olena Berg (Former Assistant Secretary of Labor for Pension and Welfare Benefit Programs), Speech held at the AFL_CIO Asset Managers Conference on September 2, 1993, as reported in Appendix B to the Institutional Shareholder Services *U.S. Proxy Voting Manual*. Emphasis added.

³³ Rule 30b1-4 under the Investment Company Act of 1940 and Rule 406(4)-6 under the Investment Advisers Act of 1940.

Long-Term Sustainable Investment: A Fiduciary Duty of the Institutional Investor?

Can institutional investors help break the short-termism chain without violating their fiduciary responsibilities to beneficiaries? A new legal study suggests they can; in fact, they might be required to do so by most jurisdictions.

An October 2005 report, entitled *A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment*, was compiled on behalf of the United Nations Environment Programme Finance Initiative (UNEP FI).³⁴ The study focuses on the largest capital market jurisdictions: Australia, Canada, France, Germany, Italy, Japan, Spain, the United Kingdom, and the United States and reviews current legal systems as well as the likely evolution of the law in each country.

The conclusion reached is that institutional investors have a far greater opportunity—and in some cases a legal obligation—to incorporate environmental, social and governance issues

into their investment decision-making than is traditionally believed. Activists and international organizations advocating corporate social responsibility often encounter resistance on the basis of the belief that fiduciary duties require asset managers to stay away from long-term investment decisions whose financial return is not clearly assessable. The report indicates that limitations based on this legal argument are illusory in most jurisdictions. On the contrary, none of the surveyed legal systems support a single-minded pursuit of profit maximization.

A panel specifically designed to encourage further discussion on this subject was held at the next Corporate/Investor Summit that The Conference Board Global Corporate Governance Research Center organized in Washington on March 29, 2006, in conjunction with the annual meeting of the Council of Institutional Investors. Further research is to be undertaken based on the March 29th discussion.

governance of issuers held in their portfolios, which may benefit all investors and not just fund shareholders.”³⁵

Reforming Director Elections

The last phase in the process of bolstering regulatory foundation for the role of institutional investors in corporate decision making was set in motion in December 2003 by the SEC’s proposal to require public companies—under certain circumstances—to include in their proxy materials security-holder nominees for election as directors. Shareholders would then be spared the considerable expense of soliciting proxies on their own. The proposed rule would be effective only in those limited situations where criteria suggest that the company

has been unresponsive to security holder concerns regarding the proxy process.³⁶ Many Summit delegates observed that the rule was unlikely to be adopted given that its level of priority in the SEC agenda has been downgraded not only under the pressure from corporate lobbyists but also as a result of the growing focus on the issue of majority voting during the 2004, 2005, and 2006 proxy seasons.

³⁴ *A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment*, UNEP Finance Initiative, October 2005. The report was compiled by a team of attorneys at Freshfields Bruckhaus Deringer.

³⁵ SEC Release Nos. 33-8188, 34-47304, *Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies*, January 31, 2003. See also SEC Release No. IA-2106, *Proxy Voting by Investment Advisers*, January 31, 2003. Emphasis Added

³⁶ See Proposed Exchange Act Rule 14a-11 and SEC Release No. 34-48626, *Security Holder Director Nominations*, October 14, 2003. As proposed, the following two series of events would trigger the nomination procedure: 1) at least one of the company’s nominees for the board of directors for whom the company solicited proxies received ‘withhold’ votes from more than 35 percent of the votes cast at an annual meeting of security holders held after January 1, 2004 at which directors were elected (provided that this event may not occur in the case of a contested election); or 2) a security holder proposal submitted pursuant to Exchange Act Rule 14a-8 providing that the company become subject to the security holder nomination procedure in proposed Exchange Act Rule 14a-11 (a); was submitted for a vote of security holders at an annual meeting of security holders held after January 1, 2004 by a security holder or group of security holders that held more than 1 percent of the company’s securities entitled to vote on the proposal for one year as of the date the proposal was submitted and that provided evidence of such holding to the company; and (b) that ‘direct access’ proposal received more than 50 percent of the votes cast on that proposal at that meeting.

Under the Delaware General Corporation Law default system of plurality vote, board nominees in uncontested elections can win a seat on the board of directors by receiving only one vote (often their own), and irrespective of the number of “withhold” votes. In 2004, shareholders submitted 12 proposals urging companies to depart from the default rule and establish a regime where directors who fail to win a majority of votes would lose the election (which is standard practice in the U.K., France, Germany, Italy, and other European countries). The issue has become the most significant development of the 2005–2006 U.S. proxy seasons, and similar proposals filed in 2005 by the

United Brotherhood of Carpenters and Joiners and other building trade unions³⁷ were officially backed by influential advocates (such as ISS³⁸, the American Bar Association³⁹, CalPERS⁴⁰, the International Corporate Governance Network⁴¹ and the Council of Institutional Investors⁴²) and voted in unexpected numbers.⁴³

Meanwhile, following the example given by Pfizer Inc in a June 2005 announcement,⁴⁴ the board of companies such as Office Depot, Microsoft, Disney, Lucent Technologies, and Circuit City proactively announced they had amended their corporate governance principles to require that any director who receives a majority of

³⁷ According to the ISS 2005 Postseason Report, in the 2005 proxy season the Carpenter union and other similar organizations have filed more than 65 majority election proposals. See *2005 Postseason Report. Corporate Governance at a Crossroad*, Institutional Shareholder Services, page 9.

³⁸ See *ISS U.S. Corporate Governance Policy— 2006 Update*, page 3.

³⁹ The American Bar Association has established a task force (led by E. Norman Veasey, former Chief Justice of the Delaware Supreme Court and co-chaired by Margaret M. Foran, vice president and secretary for corporate governance at Pfizer Inc.) to study the issue. In June, the task force had released a discussion paper on whether to adopt majority voting in director elections. The document outlined four options that the committee was considering: 1. retain the current plurality vote default rule; 2. change to a majority vote default rule; 3. adopt a modified default plurality rule, where the director must be elected by at least a one-third (or other minimum) plurality vote; and 4. leave the current plurality vote default rule in place but specifically authorize ‘against’ votes so that the board has the authority to remove or shorten the term for a director that receives more ‘against’ than ‘for’ votes. See ABA Committee on Corporate Law, *Discussion Paper on Voting by Shareholders for the Election of Directors*, June 22, 2005. Eventually, the committee released a preliminary report in which it declines (especially due to concerns about “failed elections”) to adopt a one-size-fits-all proposal to require majority voting in the election of corporate directors. While plurality voting should remain the Model Business Corporation Act’s default rule, the committee recommends a number of amendments that would permit each corporation to adopt a voting system that best fits its needs. The proposed amendments would:

- enable companies, by action of their board or shareholders, to opt-in to a modified plurality voting system by adopting a bylaw pursuant to which a director would serve for no more than 90 days following an election if that director received more votes “against” than “for” her election;
- facilitate the implementation of majority voting through the amendment of the article of incorporation so that the company may also depart from the current Model Act “holdover rule” (under which incumbent directors remain in office until their successors are elected);
- confirm the validity of corporate policies that give effect to a majority voting system (such as the requirement that directors agree to submit their resignation upon failing to receive the required vote).

See ABA Committee on Corporate Law, *Preliminary Report of the Committee on Corporate Laws on Voting by Shareholders for the Election of Directors*, January 17, 2006.

⁴⁰ CalPERS adopted a three-pronged plan to advocate majority vote election procedures for corporate directors. Under the plan, CalPERS will: seek to implement majority policies at individual companies through company bylaw and charter amendments; pursue changes to state laws to implement majority vote where feasible; seek to implement the majority vote concept at the Securities and Exchange Commission and major stock exchanges; and amend CalPERS Corporate Governance Core Principles and Guidelines to advocate majority votes for corporate directors. See the March 14, 2005 press release (“CalPERS to Seek Majority Vote For Corporate Director”).

⁴¹ According to a member consultation conducted at the July 2005 ICGN Annual Conference in London, 69 percent of the 550 members of the organization who attended the conference supported a change to the majority voting regime.

⁴² At the April 11, 2005 annual meeting, CII members approved a new policy in favor of majority voting for director elections. To actively support the change, the Council has sent a letter to the heads of 1,500 companies in the United States and volunteered to get involved in the Delaware State Bar Association’s review of the issue. For more information, see www.cii.org.

⁴³ The average level of shareholder support was 44 percent of votes cast at about 60 annual meetings, compared to 12 percent at 12 meetings in the 2004 proxy season. The highest support level were posted at Marsh & McLennan Cos., Inc. (67.3 percent) and Mack-Cali Realty Corp. (70.8 percent); the lowest at Amazon (20 percent) and Wal-Mart Stores Inc (22.3 percent). See *2005 Postseason Report. Corporate Governance at a Crossroad*, Institutional Shareholder Services, page 9.

⁴⁴ Amendments to further clarify the transition to the new rule were passed by the board in October 2005. Pfizer’s Corporate Governance Principles now specifically state that: 1. the board will act on a director’s offer to resign within 90 days following certification of the shareholder vote; 2. the board will promptly disclose via a press release its decision to accept the resignation offer or, if applicable, the reason(s) for rejecting the offer; 3. the majority voting policy will be limited to uncontested director elections; 4. any director who tenders his or her resignation shall not participate in any consideration by the board of the resignation offer. See the October 27 press release by the company (“Pfizer Amends Corporate Governance Principles to Clarify New Majority Voting Policy”), available at http://www.pfizer.com/pfizer/are/investors_releases/2005pr/mn_2005_1027b.jsp.

Hedge Funds: A New Breed of Activists?

Because of their speculative investment strategies, hedge funds are often accused of being directly responsible for short-termism. In recent months, however, some hedge funds are increasingly turning into activists, putting pressure on corporate executives to be transparent about their management, improve their corporate governance, and ultimately increase their performance.

One of the most notable examples is the alliance of hedge funds and large investors led by The Children's Investment Fund (TCI), which in May 2005 forced Deutsche Borse management to resign, inhibiting its London Stock Exchange takeover attempt. The funds are now under investigation by BaFin, the German exchange commission, on suspicion that their concerted action violated securities laws.

Do activist hedge funds encourage long-termism? The current phenomenon is too recent to be fully assessed,

but a few commentators have doubts and have raised questions about whether, by being active, such hedge funds “are creating a short-term pop in share prices, yet leaving the companies less healthy for the long haul.”⁴⁶ Hedge fund activism is expected to increase, especially in Europe, where hedge funds see even more companies they consider to be underperforming. But it may well be that these investors are turning to activism, not because they sincerely support strategic decisions based on long-term shareholder value, but simply “because it is getting tougher to show top-notch returns as more hedge funds pursue similar investment ideas and overall market volatility drops.”⁴⁷ In addition, especially in the United States where hedge funds are not allowed to advertise, their managers may also be driven by self-publicity.⁴⁸

withhold votes in an uncontested election submits his/her resignation to the board (which will, in turn, consider it and make recommendations).

Although the majority vote rule does not affect the authority to select director nominees (which is retained by the board), many argue that it would instill democratic values in a process where the role of shareholders has generally been considered to be merely symbolic. In a paper published by Institutional Shareholder Services, adoption of a majority voting mechanism is deemed to be the item in the “unfinished agenda of corporate governance reform” that “would transform the way corporate directors are elected in the United States and [that] holds the potential to enable a new era in constructive dialogue between corporations and their owners.”⁴⁵

The 2006 proxy season confirms that momentum is growing to embrace majority voting mechanisms. It is not hard to imagine how this development could magnify the voice of institutional investors in matters related to the selection of board members and the definition of future business strategies.

Given recent developments—the growth of institutional investor economic and voting clout, their growing ability to communicate with each other, and their inclination to long-term investing (notwithstanding the entrance of hedge funds into the mix)—Summit delegates concluded that pension funds and other large asset management institutions have the potential to contribute to breaking the investment link of the short-termism chain.

⁴⁵ ISS Institute for Corporate Governance, *Majority Voting in Director Elections*. From the Symbolic to the Democratic, 2005, page 1.

⁴⁶ Gregory Zuckerman, “Big Shareholders Are Shouting Ever Louder. Activists Pressure Executives to Unlock Value, Even Using Pirate, Bulldog in Their Monikers,” *The Wall Street Journal*, November 23, 2005.

⁴⁷ *Id.*

⁴⁸ Ian Sax, “The New Face of Activism,” *IR Magazine*, October 2005, page 27.

The Pay-for-Performance Debate

Summit delegates discussed the subject of pay-for-performance, remarking that many of the issues of short-termism and how to properly align executive actions with long-range strategic goals are at the core of the current debate on the adequacy and proper design of executive compensation.

The issue of correlating the level of remuneration received by senior executives to their actual performance has taken center stage as public indignation accompanied revelations that individuals directly responsible for a series of catastrophic business results would continue to receive hefty paychecks (or severance packages), as well as the support of their boards of directors.

Summit delegates emphasized the importance of establishing appropriate information flows between corporations and investors (and between corporations and financial analysts) on how executive compensation schemes support the achievement of a durable business strategy. Delegates observed that the pressure on corporations to revisit the pay-for-performance issue comes from various fronts: investors, regulators, investor intermediaries, and the courts.

Pressure from Investors

In 2005, in particular, pay-for-performance became the hot-button issue of the U.S. proxy season. According to data for the 2005 proxy season published by Institutional Shareholder Services Inc. (ISS), institutional investors filed 36 pay-for-performance proposals, almost five times the number of similar proposals that appeared on the company ballots during the 2004 proxy season.⁴⁹

⁴⁹ See the ISS 2005 Postseason Report, page 21, available at <http://www.issproxy.com>. Another indicator of the sensitivity of institutional investors to compensation issues is the growing number of so-called “claw-back” proposals. Typically, the claw-back proposal calls for the board of directors to adopt a policy according to which, in the event of a restatement of financial results, the board will review all performance-based bonuses and other awards that were made to senior executives, and recoup that compensation to the extent that their performance targets were not achieved.

Compensating Extra-Financial Performance: Investors’ Initiatives in the United Kingdom

Although executive compensation is a common theme on both sides of the Atlantic, the scope of the current debate on pay-for-performance in the United Kingdom appears broader. Specifically, in the United Kingdom, the debate involves the issue of devising pay and incentive schemes to properly remunerate (and boost) not only financial but also extra-financial results (in areas such as customer and employee satisfaction, corporate reputation, health and safety or the environment). A discussion paper jointly prepared by Henderson Global Investors (a leading investment management firm) and the Universities Superannuation Scheme (USS) explained USS’ intention to include extra-financial measures of performance in their ongoing discussion with portfolio companies on their remuneration arrangements.

According to the report, extra-financial measures:

“provide an indication of the extent to which key drivers of long-term value creation have been incorporated into the objectives set for both individuals and the organization through the linkage to executive remuneration... Focusing just on financial objectives may sometimes mean that underlying extra-financial factors that are essential for long-term success do not receive adequate attention... The precise mix of metrics that best links strategy and remuneration will of course be specific to each individual company. But linking remuneration to a more balanced range of measures than is currently common helps to ensure that a focus on ‘ends’ (financial performance) does not cause the ‘means’ (management of a range of tangible and intangible assets) to be eclipsed.”

See *Getting What You Pay For: Linking Executive Remuneration to Responsible Long-Term Corporate Success. A Discussion Paper*, February 2005, available at www.henderson.com.

In certain cases, such as Textron and Lucent Technologies, the issue drew as many as 48 percent of total shareholder votes cast.⁵⁰ Although the proposals were not always overwhelmingly backed by shareholders, data on filings indicate that active institutional investors are paying increasing attention to the tie between compensation and the results delivered by management. The trend is expected to continue during future proxy seasons,⁵¹ and should be fostered by widely anticipated changes in the SEC's executive compensation disclosure rules.

Pressure from Regulators

Soon after his appointment, U.S. SEC Chairman Christopher Cox indicated that ensuring the transparency and comparability of information on executive pay is one of the main priorities in his agenda.⁵² Current disclosure rules on corporate compensation date back to 1992. They already require the itemization of package components, comparative data for similar companies in the same industry, as well as the discussion of factors and criteria used by the compensation committee as bases for determining the CEO's compensation.⁵³

On January 27, 2006, the Securities and Exchange Commission proposed rules⁵⁴ amending current disclosure requirements for executive compensation (see box on page 23).

Increased disclosure of senior manager compensation is also sought by a new bill currently being discussed in the U.S. Congress. "The Protection Against Executive Compensation Abuse Act"⁵⁵ intends to ensure shareholders more information about pay packages granted to senior executives, and empower shareholders to take action against management abuse and self-dealing. Among other things, the statute would require public companies to include in their annual reports and accompanying proxy solicitations a comprehensive "executive compensation plan," disclosing:

- any and all types of compensation paid (or to be paid) to top executives (i.e. basic compensation, long-term and short-term incentives, pensions, golden parachute agreements, personal use of private jets and corporate apartments and other currently hidden compensation);
- the corporate policy on the remuneration of corporate executives, with a discussion of the short and long-term performance measures used to set the top executives' compensation;
- indication as to whether such measures were met in the preceding year; and
- the corporate policy for recapturing any form of incentive compensation that appears to be unjustified because the set benchmarks were not met.

Finally, the bill requires that such an "executive compensation plan" obtains the annual approval not only

⁵⁰ Pay-for-performance proposals won 38 percent votes at Abbott Laboratories and PG&E Corp., and 32 percent at Coca-Cola Co. and Weyerhaeuser Co.

⁵¹ The American Federation of State, County & Municipal Employees (AFSCME), for example, announced its plan to file a dozen shareholder proposals in 2006 on executive pay issues, including pay for performance, compensation caps, retirement benefits and severance. See the interview with Richard Ferlauto, the union's director of investment policy, published by ISS *The Friday Report* on July 1, 2005.

⁵² See "One on One with SEC Chairman Christopher Cox," NBR.com, August 10, 2005: "Executive compensation is much in the news and there have been some very notorious cases of apparent excess. It should be, of course, in the main up to shareholders to discipline that kind of activity, but in order for shareholders to do that, they've got to have good information. I think you can look in the near future to the SEC for some improved rules on disclosure to make sure that, for example, shareholders can have one number, that the different kinds of executive compensation add up to a number that's comparable executive to executive and company to company and at the same time that this information is provided in a timely way before rather than after the fact."

⁵³ See Item 402 of Regulation S-K. Under Instruction 1 to Item 402(k), boilerplate language should be avoided in describing factors and criteria underlying awards or payments of executive compensation in the statement required. In the same year, the SEC had reversed a prior position on the exclusion of shareholder proposals related to the remuneration of senior executives, noting that, because of the public concern over the ever-increasing size of pay packages, such issues can no longer be considered matters of ordinary business; instead, they demand the oversight of all shareholders. See Baltimore Gas and Electric Co., SEC No-Action Letter, 1992 WL26607, *3 (Feb. 13, 1992).

⁵⁴ SEC Release No. 33-8655, 34-53185 ("Executive Compensation and Related Party Disclosure"), January 27, 2006, available at <http://www.sec.gov/rules/proposed/33-8655.pdf> The proposed rules would also require a table similar to the Summary Compensation Table (see box on page 23) to be included for directors, but only for the last year.

⁵⁵ H.R. 4291 ("The Protection Against Executive Compensation Abuse Act"), introduced by Rep. Barney Frank (D-Mass) on November 10, 2005, available at <http://thomas.loc.gov/home/c109query.html>. The bill would introduce the described provisions by amending Section 16 of the Securities Exchange Act of 1934.

The SEC Proposal for New Compensation Disclosure Rules

The SEC proposal on executive compensation disclosure reform, published for comments from the business community on January 27, 2006, includes the following requirements:

- A new narrative section likened to the MD&A and entitled *Compensation Discussion & Analysis*, for the description of the company's compensation policy and program objectives. The section would replace the compensation committee report and the stock performance graph included in the current compensation disclosure.
- A reorganized Summary Compensation Table, which would remain the main vehicle for disclosing three-year compensation. According to the proposal, the table would be required for the CEO, the CFO and the three other highest paid executive officers and the directors. It would include additional information such as:
 - a) a total compensation column, for a single figure representing the total annual compensation of each executive officer;

b) a total dollar value for stock-based awards (i.e. stock and stock options), measured at grant date fair value and computed pursuant to the recently revised FASB's Statement of Financial Accounting Standards No. 123(R) ("Share-Based Payment"). Note that under current rules companies only disclose the number of awarded stock options;

c) a column for "all other compensation," including aggregate increases in the actuarial value of pension plans accrued during the year, earnings on deferred compensation and defined contribution plans, and perquisites totaling USD 10,000 or more (current threshold is USD 50,000).

- Two supplemental tables reporting Grants of Performance-Based Awards and Grants of All Other Equity Awards.
- Additions to current tabular disclosure of Outstanding Equity Interests and Retirement Plans (including vested equity compensation and retirement plan payments received by each executive officer during the last year).

of the company's board of directors or compensation committee, but also of shareholders.⁵⁶

The bill has been welcomed by many political leaders, and has immediately found the support by shareholder activist groups such as The Corporate Library⁵⁷ and The American Federation of Labor and Congress of Industrial Organizations,⁵⁸ among others. It is worth noting that, if passed by the Congress, the statute will accelerate the process of convergence of disclosure standards between the United States and Europe. On December 14, 2004, the European Commission adopted a recommendation on executive and director remuneration,⁵⁹ urging EU

Member States to pass harmonized regulatory reforms including the requirements for a remuneration policy, for itemized disclosure of what each executive (or director) is entitled to from the company, and for the approval (or, at a minimum, the advisory vote) of shareholders.

⁵⁶ The bill also requires that shareholders separately approve the granting of any additional compensation for top executives that coincides with the sale or purchase of substantial company assets.

⁵⁷ See the statement released by Nell Minow of The Corporate Library on November 9, 2005, in support of the legislation to improve disclosure and provide shareholders "a chance to reject proposals that undermine the company's sustainability." A copy of the statement is available at: http://www.house.gov/banking_democrats/ExecCompCorpLibraryStatement.pdf

⁵⁸ See the statement released by Richard Trumka (AFL-CIO Secretary Treasurer) on November 10, 2005: "America's working families are outraged by the growing size of CEO packages. By any standard, today's executive compensation packages are excessive. ...Year after year, CEO pay levels show little apparent relationship to corporate profits, economic growth, or executive performance. Moreover, a poorly designed executive compensation package can reward decisions that are not in the long-term interests of a company, its shareholders and employees...Using the Protection Against Executive Compensation Abuse Act as a starting point, we strongly urge the SEC to make executive compensation disclosure reform a priority."

⁵⁹ 2004/913/EC, Commission Recommendation of 14 December 2004 on fostering an appropriate regime for the remuneration of directors of listed companies. The recommendation is published in OJ L 385/55 of December 29, 2004. It should be noted that the term "director" is used according to the European tradition and means "any member of the administrative, managerial or supervisory bodies of a listed company" (see Section I, Article 2.1).

Pressure from the Judiciary

The threat of an enforcement action is also inducing boards of directors and independent compensation committees to become proactive in the development of new best practices. For example, in September 2004, the SEC initiated an enforcement proceeding against General Electric for its failure to provide a comprehensive description of the benefits conceded to former Chairman and CEO Jack Welch under an employment and post-retirement consulting agreement.⁶⁰ Similar principles arose in connection with the December 2004 settlement the Walt Disney Company reached with the SEC on the charges that the company had not disclosed certain related-party transactions such as the employment of three children of its directors (with annual remuneration that in some cases exceeded \$150,000).⁶¹

Finally, in August 2005, the influential Delaware Court of Chancery issued a long-awaited decision in the *Disney vs. Ovitz* case involving executive compensation.⁶² Despite its conclusion not to hold the directors accountable to today's corporate governance standards for a business judgment made in the mid-90s, the court criticized the members of the Disney board for allowing the company's former COO Michael Ovitz to walk away with a \$140 million severance package. Aware of the higher degree of scrutiny to which their business judgment is exposed, many directors serving on compensation committees report they have been spending additional time preparing the committee's compensation report, ensuring that it fully reports on the deliberations undertaken regarding pay-for-performance and senior executive pay.⁶³

Pressure from Rating Agencies and Proxy Advisors

Companies providing corporate governance ratings, including proxy advisory firms, closely monitor corporate practices in the area of executive compensation. Recently, these organizations have focused increasing attention on what they consider to be unjustified and excessive compensation, thereby contributing to raising the "best practice" bar.

For example, updates in the Institutional Shareholder Services (ISS) U.S. Corporate Governance Policy for 2006⁶⁴ deal with the issue of whether companies should provide "tally sheets" for CEOs. ISS offers an interpretation of SEC disclosure rules that anticipates possible regulatory changes and encourages their prompt approval. Specifically, the document states that "the current SEC requirements on pay disclosure are inadequate for shareholders to readily determine a complete executive pay package and understand the linkage between pay and performance. Companies should meet the spirit of the requirements by providing more details and the rationale of executive pay. A tally sheet or a total wealth accumulation approach that lists all major pay components, such as base salary, bonus, long-term equity, deferred compensation, supplemental retirement benefit, and perquisites should be detailed, explained, and total."

Consequently, "for those companies that do not meet a minimum standard of tally sheet disclosure, ISS will note the deficiency and provide cautionary language in its analysis." In addition, "in 2007, ISS will consider recommending withhold votes from the compensation committee and potentially recommending votes against proposed or amended equity plans if compensation disclosure is not improved and enhanced proxy disclosure in the form of a tally sheet is not provided." While waiting for the SEC to revise its requirements, ISS provides the following table as a template for a CEO tally sheet (see box on page 25).

⁶⁰ See SEC Release No. 50426, *In the Matter of General Electric Company*, September 23, 2004.

⁶¹ See SEC Release No. 50882, *In the Matter of The Walt Disney Company*, December 20, 2004.

⁶² *In Re The Walt Disney Company* (Del. Ch. August 9, 2005).

⁶³ Discussions held at meetings of The Conference Board Directors' Institute indicate that directors are under significantly greater pressure to review top executive compensation.

⁶⁴ *ISS U.S. Corporate Governance Policy 2006 Updates*, Institutional Shareholder Services, Inc., available at www.issproxy.com

Template for CEO Tally Sheet

Component	Amount Earned/Granted	Description
Base salary	Current figure	Explanation of any increase in base salary
Annual incentive	Target Actual earned:	Explanation of specific performance measures and actual deliverables State amount tied to actual performance State any discretionary bonus
Stock options	Number granted: Exercise price: Vesting: Grant value:	Rationale for determining the number of stock options issued to CEO Accumulated dividend equivalents (if any)
Restricted stock	Number granted: Vesting: Grant value:	Performance-based or time-based Rationale for determining the number of restricted stock issued to CEO Accumulated dividends on vested and unvested portion
Performance shares	Minimum: Target: Maximum: Actual earned: Grant value:	Explanation of specific performance measures and actual deliverables Any dividends on unearned performance shares
Deferred compensation	Executive portion: Company match (if any): Accumulated executive portion: Accumulated company match (if any):	Provide structure and terms of program Explanation of interest, formulas, minimum guarantees or multipliers on deferred compensation Any holding periods on the company match portion Funding mechanism
Supplemental retirement benefit	Actual projected payment obligations:	Provide structure and terms of program Explanation of formula, additional credits for years not worked, multipliers or interest on SERPs Funding mechanism
Executive perquisites	Breakdown of the market value of various perquisites	Types of perquisites provided. Examples: company aircraft, company cars, etc.
Gross-ups (if any)	Breakdown of gross-ups for any pay component	
Severance associated with change-in-control	Estimated payout amounts for cash, equity, and benefits	Single trigger or double trigger
Severance (termination scenario under “for cause” and “not for cause”)	Estimated payout amounts for cash, equity, and benefits under different scenarios	
Post-retirement package	Estimated value of consulting agreement and continuation of benefits	
Estimated total package	\$	

Source: ISS U.S. Corporate Governance Policy 2006 Updates

The Conference Board Compensation Reports

Evidence indicates that recent pressure from institutional investors, regulators, rating agencies and proxy advisors may be tempering historic increases in CEO compensation.

The Conference Board's latest findings on CEO compensation⁶⁵ still show significant increases in the total pay levels, confirming trends reported in other recent studies.⁶⁶ Compared with 2003 levels, 2004 median total current compensation (salary plus year-end bonus) for CEOs was higher in all 14 industries surveyed, with the energy industry indicating an increase as high as 46.1 percent.

Nonetheless, it should be noted that the current rate of increase is much lower than in the 1990s, as companies have now restricted those stock option grants that were inflating compensation figures a decade ago. Today, most of the increase in CEO compensation appears to be the result of more traditional performance incentives, such as annual bonuses tied to the higher levels of profitability realized during the last few quarters.

Table 3

2004 Median Total Compensation for CEOs

Energy	46.1%
Financial services	31.0
Transportation	27.3
Construction	26.0
Manufacturing	19.9
Insurance	19.1
Telecommunications	18.3
Diversified service	16.2
Utilities	15.8
Trade-wholesale	15.3
Computer services	14.6
Communications	13.1
Trade-retail	10.4
Commercial banking	9.7

Source: The Conference Board

Table 4

2004 Median Bonus Awards for CEOs

Construction	278%
Financial services	209
Insurance	144
Transportation	103
Telecommunications	102
Energy	101
Manufacturing	100
Utilities	99
Diversified service	98
Trade-wholesale	90
Computer services	86
Trade-retail	85
Communications	82
Commercial banking	75

Source: The Conference Board

In addition, ISS is adopting a formal policy to recommend withholding votes from compensation committee members if the company has poor performance practices, including, for example:

- bonus payouts practices without justifiable performance linkage; and
- performance metrics that are changed during the performance period.

Finally, according to the revised guidelines, ISS will factor in long-term stock price performance when determining voting recommendations for or against director nominees in uncontested elections.

Summit delegates noted that that the issues of short-termism and how to properly align executive actions with long-range strategic goals are at the core of the current debate on pay-for-performance.

⁶⁵ Charles Peck, Henry M. Silvert, and Judit Torok, *The 2005 Top Executive Compensation Report*, The Conference Board, Research Report 1377, 2005. Findings are based on 2004 proxy and financial statements data compiled by eComp Data Services.

⁶⁶ *CEO Pay 2004*, The Corporate Library, October 2005. According to The Corporate Library report, between 2003 and 2004 total annual compensation for CEOs rose by a median of 30.2 percent, significantly

higher than the prior year's 15.0 percent. As for corporate directors, a study tracking outside directors' compensation programs at 100 of the largest U.S.-based companies listed on the NASDAQ and the New York Stock Exchange, found that total compensation increased 17 percent over last year at the largest NYSE companies and 4 percent at the largest NASDAQ companies: see *Director Compensation: NASDAQ 100 vs. NYSE 100*, Frederic W. Cook & Co., Inc., September 2005.

Reporting Extra-Financial Measures of Performance

In order to understand and communicate to the market whether the company is progressing in its strategic direction and on track to meet its long-term objectives, corporate management needs to employ the right set of performance measures. For the most part, the choice of such measures depends on the specificities of the organization and the industry in which it operates. Nonetheless, because business success translates into much more than earnings growth and return on investment, it is important that performance assessment is based on a balanced combination of financial and extra-financial indicators. If that is not the case, management may run the business ineffectively, while potential remains

unutilized or poorly leveraged; on their part, investors and financial analysts run the risk of looking at an incomplete picture, therefore making unsound investment decisions or recommendations.

At the London Summit, The Conference Board Global Corporate Governance Research Center discussed its research on long-termism, which dates from the mid 1990s and demonstrates the importance to companies of having an enterprise-wide process (with contributions from board members, executives, and line personnel) for the selection of the appropriate range of financial and extra-financial metrics tracking the success of the business.⁶⁷

What Key Performance Metrics?

Richard Dobbs and Timothy Koller (“Measuring Long-Term Performance,” *The McKinsey Quarterly*, 2005 Special Edition: *Value and Performance*, pages 17-27) identified eight categories of key performance metrics:

Short-term metrics, of 3 types:

- Sales productivity metrics, indicating the factors underlying recent sales growth (i.e. the pace of retail store openings);
- Operating-cost productivity metrics, indicating the factors underlying unit costs (i.e. the cost of building a car);
- Capital productivity metrics, indicating how well a company uses its working capital (inventories, receivables, and payables) and its property, plant, and equipment (i.e. return on investment capital (ROIC)).

Medium-term metrics, also of 3 types:

- Commercial-health metrics, indicating whether a company can sustain or improve its current revenue growth (i.e. investment in launching a new product brand);
- Cost structure health metrics, indicating a company’s ability, as compared with their competitors’, to manage its costs over three to five years (i.e. effectiveness of a program like Six Sigma, used by companies such as GE to constantly and continually reduce their costs);
- Asset health metrics, indicating how well a company maintains and develops its assets (i.e. average time between renovations of facilities in a hotel chain).

Long-term strategic health metrics,

indicating the ability of a company to sustain its current operating activities and to identify and exploit new areas of growth (i.e. progress in selecting partners for mergers or for entering a market).

Organizational health metrics,

indicating whether the company has the people, the skills, and the culture to sustain and improve its performance (i.e. employee retention statistics).

⁶⁷ See Carolyn K. Brancato, *Enterprise Risk Management Systems. Beyond the Balanced Scorecard*, The Conference Board, Special Report 05-04-SR, 2005. Also by Brancato: *Communicating Corporate Performance: A Delicate Balance*, The Conference Board, Research Report 1188, 1997;

and *New Corporate Performance Measures*, The Conference Board, Research Report 1118, 1995. Finally, see Stephen Gates, *Aligning Strategic Performance Measures*, The Conference Board, Research Report 1261, 1999.

What Is an Intangible?

Much of today's understanding of the role played by intangibles in business performance is owed to Baruch Lev (Professor of Accounting and Finance with the Stern School of Business at New York University).⁶⁸ Lev defines intangibles as “nonphysical claim[s] to future benefits,” and classifies them as:

Discovery (i.e. innovative products or services that result from R&D expenditures).

Organizational Practices (i.e. an innovative production system, customer satisfaction program, or marketing approach, such as the direct customer marketing of built-to-order computers via telephone and the Internet that transformed Dell into the leader of the PC-maker industry).

Human Resources (i.e. innovative personnel and compensation policies, such as investment in training and collaboration programs with universities and research centers to facilitate the recruitment of highly qualified employees).

Intangibles may also be created through a combination of these three sources of innovation (as is the case for Coca-Cola's brand, to name one, which succeeded thanks to a secret formula and marketing savvy). Intensified business competition and the advent of information technologies

have transformed the structure of the modern corporation and help explain the dramatic surge of the importance of intangibles as business value drivers since the mid-1980s. Lev observes how “wealth and growth in today's economy are driven primarily by intangible (intellectual) assets. Physical and financial assets are rapidly becoming commodities, yielding at best an average return on investment. Abnormal profits, dominant competitive positions, and sometimes even temporary monopolies are achieved by the sound deployment of intangibles, along with other types of assets.”⁶⁹

Suboptimal deployment of intangibles favors pursuit of short-term projects, instead of sustainable, long-term innovation. Lev believes that a social harm may result from the deficiencies on intangibles' disclosure, as it means that the business corporation is not pursuing those durable value growth objectives needed to benefit the whole social community.

The most important lesson that may be derived from Baruch Lev' research on intangibles regards their ability to create corporate value through interaction with tangible and financial assets.

Historically, manufacturing companies have derived most of their firm values from tangible assets like plant and equipment. Instead, in a modern, service-oriented business organization, a firm's value rests on a variety of intangible assets, including the product of employees' creativity (for which the company may obtain legal protection through copyrights, patents, and trademarks), innovative production mechanisms or marketing processes, know-how, workforce expertise and professional development, quality controls, customer satisfaction and third-party relationships. Increasingly, organizations must be able to rely on an enterprise-wide process designed to:

- maintain an asset inventory where intangibles are classified according to such criteria as their nature, location, and immediate availability;
- quantify their intrinsic value, their propensity to be strategically deployed and their actual contribution to the long-term growth of the business; and
- clearly communicate such information to the market.

If adequately implemented by management, a process of this sort ensures that:

- the business potentials are unlocked, and the company is set to meet its durable objectives; and
- the investment community fully appreciates such potentials and rewards the company for its long-term commitment.

⁶⁸ Baruch Lev, *Intangibles. Management, Measurement, and Reporting*, Brookings Institution Press, 2001. Also see Zhen Deng, Baruch Lev and Francis Narin, “Science and Technology as Predictors of Stock Performance,” in John Hand and Baruch Lev (edit.), *Intangible Assets. Values, Measures, and Risks*, Oxford University Press, 2003. Also “Communicating Knowledge Capabilities,” NYU Stern School of Business Working Paper, 2003; “The Capitalization, Amortization, and Value Relevance of R&D,” *Journal of Accounting and Economics*, 21, 1996, page 107-138 (with Theodore Sougiannis); “On the Usefulness of Earnings and Earning Research: Lessons and Directions from Two Decades of Empirical Research,” *Journal of Accounting Research* (supplement), 27, 1989, page 153-192.

⁶⁹ Baruch Lev, *Intangibles. Management, Measurement, and Reporting*, page 1.

At the Summit, delegates discussed how the debate on extra-financial indicators of performance is intertwined with the stock market short-termism issue. There was agreement that improving the quality of the information flow on corporate assets is essential to project strategic and investment decisions on a longer timeline. “I do not believe that extra-financial measures should be rigidly identified in a one-size-fits-all solution, but it is clear that corporations need to move away from purely financial guidance to the market,” said an executive at a large investment fund. It is proven that the correlation between financial measures of performance and share prices is limited and further diminishing: empirical studies indicate that, on average, only 25 percent of a company’s market value can be attributed to accounting book value, while the remaining 75 percent consists of intangible assets and expectations of future growth.⁷⁰ Current annual reports, with their excessive emphasis on financial performance measures, may therefore lack an adequate disclosure of the major value drivers of performance.

The Summit discussion stressed the importance of communicating information on intangibles to the market. A company with an effective system to disclose extra-financial measures of performance may well enjoy a major competitive advantage, as its investor relations become more sophisticated. To be sure, the reputation of the organization in the marketplace can benefit from the company’s transparency. In fact, comprehensive disclosure provides shareholders and stakeholders the clarity they need to fully understand the real business value drivers and assess whether the stated strategy is being properly implemented.

Moreover, there is evidence that financial analysts who are provided with more comprehensive business information (including information on value drivers of long-term performance) tend to issue more positive recommendations on the company’s securities, as they

base their estimates upon such factors as confidence in the market positioning of the firm.⁷¹ As a result, because of the improved relationship with investors and analysts, the company may enjoy a lower cost of capital and be better suited to attract and retain the talent it needs to pursue its long-term goals.

Yet annual and quarterly reports filed by public companies often suffer from information asymmetries (which limit the comparability of disclosed data even with respect to businesses in the same industry) and other shortcomings. For example, under generally accepted accounting rules, investments on intangibles are expensed, not capitalized like those on physical and financial assets; as these expenditures increase, earnings per share typically decrease. In other words, current financial reporting principles operate as a disincentive to invest in research, innovation, and other future shareholder value drivers.⁷²

⁷⁰ Baruch Lev, *Intangibles. Management, Measurement, and Reporting*. For similar conclusions, see Robert Eccles, “The Performance Measurement Manifesto,” in *Measuring Corporate Performance*, Harvard Business School Press, 1991 (reprinted in 1998). On the use of extra-financial metrics in the investment decision-making process, see James O’Loughlin and Raj Thamootheram, *Enhanced Analytics for Enhanced Performance: The Business Case for Extra-Financial Factors in Investing*, Universities Superannuation Scheme, March 2006.

⁷¹ Alison Thomas, “A Tale of Two Reports,” *European Business Forum*, Issue 16, Winter 2003/4, page 79-81, describing the PricewaterhouseCoopers’ project of submitting to analysts two different versions of the annual report of a Danish company, Coloplast, awarded the 2002 Best Intellectual Capital Reporting award by the Danish Borsen. PwC found that the average revenue and earnings forecast prepared by analysts provided with the version of the report inclusive of extra-financial disclosure was actually lower than the forecast prepared by the researchers who had received a corporate document inclusive of the sole financial information. Yet despite the lower forecast, members of the group with the complete information set were overwhelmingly in favor of buying the stock.

⁷² See transcripts from *Adapting a 1930’s Financial Reporting Model to the 21st Century: Hearing Before the Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs, United States Senate, 106th Congress, July 19, 2000*. Testimonies were made by the following experts: Robert K. Elliott (Chairman, American Institute of Certified Public Accountants), Baruch Lev (Professor of Accounting and Finance, New York University), Steve M. Samek (Partner, Arthur Andersen), Peter J. Wallison (Resident Fellow, American Enterprise Institute) and Michael R. Young (Partner, Willkie Farr & Gallagher). As per Mr. Elliott’s testimony: “Today, transparency is more widely recognized as an economic advantage than it is ever before... Unfortunately the current accounting model is somewhat out of date. It is very much based on the assumption that profitability depends on physical assets, like plant and machinery; on raw materials, like coal, iron ore, sheet metal, electrical wire, and plastic; in other words, on the tangible inputs needed to produce tangible products. This is the accounting model of the industrial age. But we are no longer in the industrial age. We still have elements of it, of course, and we always will, but we have moved deeply into the information age. We now have information companies, companies that do research and produce findings that they hope to profit from... The role of intellectual inputs that ultimately lead to sales has multiplied enormously.”

On this point, Summit delegates discussed the unprecedented change corporate reporting is undergoing.

- First—they agreed that no market participant truly believes that the traditional corporate annual reports add value to the investment decision-making process. According to a recent study of the high-tech industry in the United States and Canada, only 7 percent of investors, 6 percent of analysts, and 13 percent of company executives found reported financial information very useful in determining the true value of a company.⁷³ In practice, market participants gather the knowledge they need through other avenues, such as in-depth conference calls with management and inquiries to investor relation officers.
- Second—Summit delegates acknowledged the effort made by leading executives to provide supplemental information to the market, by voluntarily adopting conceptual frameworks such as Economic Value Added (EVA), Cash Flow Return on Investment, and the Balanced Scorecard.⁷⁴
- Third—they recognized that progress is being made by associations and self-regulatory bodies of accounting and auditing professionals in reconsidering disclosure principles and methodologies so as to provide a more complete and reliable representation of where the business stands and where it intends to go. In some cases, these projects were developed under the wing of legislatures or governments, which were receptive to the stock market need for more meaningful corporate information. In other cases, proposals are being advocated among corporate and investor leaders, in the hope of garnering the largest possible support from the business community and, eventually, the official ratification by public institutions.

The following sections describe two of the major initiatives mentioned at the July 2005 London Summit.

The Operating and Financial Review in the United Kingdom

In the United Kingdom, the government has contemplated the inclusion in The Companies Act 1985 (“Investment Companies and Accounting and Audit Amendments”) Regulations 2005 of a requirement for directors of quoted companies to prepare a narrative Operating and Financial Review (OFR).⁷⁵ Under the new British approach to reforming business reporting, disclosure would be the product of a top-down analysis, where the main input comes from the corporate board. “The OFR process can provide an opportunity for Boards to question the depth and breadth of information they use and, as a result, assess whether the limited time available in Board meetings is being focused on the right issues. How many Boards routinely receive lead performance indicators that go beyond traditional financial numbers and how much time is devoted to strategy and activities critical to value creation? Over time, the OFR will provide Directors [and management] with a more comprehensive picture of corporate performance, [including] new insights into the health and sustainability of the business.”⁷⁶

⁷⁵ It should be noted, however, that in November 2005 the British government scrapped the Operating and Financial Review requirement from the Company Law Reform Bill, due to concerns about the imposition of unnecessary burdens on UK companies. In the following months, as a result of the legal challenge established and won by the environmental organization “Friends of the Earth,” the government was persuaded to extend the consultation on the matter. On January 20, 2006 a group of investors, trade bodies and expert organizations co-coordinated by SustainAbility, Tomorrow’s Company and USS (Universities Superannuation Scheme) wrote a letter to Alan Johnson MP, Secretary of State for Trade and Industry, to support the need for enhanced business disclosure.

⁷⁶ *Operating and Financial Review. Preparers’ Guide*, PricewaterhouseCoopers, 2005; “Directors will need to exercise much greater judgment than historically to determine what information investors need... Directors will have to consider, ‘to the extent necessary’, what information relating to key relationships (e.g. customers and suppliers), brands, innovation, employees and social and environmental issues are important in evaluating strategy and performance.” Also see *Director’s Guidance on Preparing an Operating and Financial Review*, Institute of Chartered Accountants in England and Wales (ICAEW), 2005. In the United Kingdom, the idea that companies should tailor their reporting to their specific audience (considering their investor base, research specialists, etc.) is supported in Tomorrow’s Company’s studies of corporate reporting; see: *Sooner, Sharper, Simpler: A Lean Vision of an Inclusive Annual Report*, Tomorrow’s Company, 1998, available at: <http://www.tomorrowcompany.com/publications.htm>. Also, on the same argument for the need of “inclusive reporting,” see Mark Goyder, “Inclusive Reporting: 2007 and How to Get There,” *Ethical Corporation Magazine*, May 2002, page 29-31.

⁷³ See Robert Eccles et al., *The Value Reporting Revolution: Moving Beyond the Earnings Game*, page 4.

⁷⁴ Robert S. Kaplan and David P. Norton, *The Balanced Scorecard*, Harvard Business School Press, September 1996. The book expands on their famous article “The Balanced Scorecard. Measures that Drive Performance” published in the *Harvard Business Review* in 1992.

A reporting standard subsequently issued by the British Accounting Standards Board (ASB) expands on the content of the legal requirement. The OFR shall, among other things:

1. “Set out an analysis of the business through the eyes of the Board of Directors
2. Focus on matters that are relevant to the interests of the investors
3. Have a forward-looking orientation identifying those trends and factors relevant to the investors’ assessment of the current and future performance of the business and the progress towards the achievement of long-term business objectives
4. Complement as well as supplement the financial statements, in order to enhance the overall corporate disclosure...”⁷⁷

An OFR Disclosure Framework (see box), also included in the ASB reporting standard, indicates that the new disclosure should be “underpinned by the financial and non-financial key performance metrics used to assess progress against stated objectives, as well as other measures and evidence.”

OFR Disclosure Framework

The nature, objectives and strategies of the business	Resources, risks and uncertainties, and relationships	Current and future development of performance	Financial position
<p>Description of business and external environment</p> <p>Objectives to generate or preserve value over the longer term</p> <p>Strategies for achieving the objectives</p>	<p>Description of resources, tangible and intangible, available and how they are managed</p> <p>Description of principal risks and uncertainties and the Directors’ approach to them</p> <p>Information about significant relationships with stakeholders other than investors who may directly impact performance</p>	<p>Significant features of the development and performance of the business</p> <p>Main trends and factors likely to impact future performance</p>	<p>An analysis of financial position and critical accounting policies</p> <p>Discussion of the capital structure</p> <p>Discussion of the treasury policies and objectives</p> <p>Discussion of the cash inflows and outflows, ability to generate cash to meet commitments and fund growth</p> <p>Discussion of current and prospective liquidity</p>
<p>Underpinned by the financial and non-financial Key Performance Indicators (KPIs) used to assess progress against stated objectives, as well as other measures and evidence.</p>			

Source: *Operating and Financial Review. Preparers’ Guide*, PricewaterhouseCoopers, 2005. The Table is adapted from ASB Reporting Standard 1.

The Enhanced Business Reporting Initiative in the United States

In the United States, for many years, financial statements included in corporate reports have been accompanied by a narrative referred to as management’s discussion and analysis (MD&A). MD&A was first made mandatory by the SEC in 1974. Its scope expanded over the course of the following three decades, through a series of amendments and interpretative releases, but remains narrow. All the MD&A really intends to provide is a commentary of “financial conditions, changes in financial conditions, and results of operations.”⁷⁸ Although a December 2003 SEC interpretative release calls for the identification and discussion of “key performance indicators, including non-financial performance indicators,”⁷⁹ in practice the purpose is often defeated by the preparers’ use of boilerplate language and repetitions of other parts of the annual report. In fact, in the aftermath of the Enron scandal, the SEC conducted a thorough review of all Fortune 500 annual reports for the 2002 fiscal year; a large number of

⁷⁷ See ASB Reporting Standard 1 (“RS1”), May 10, 2005.

⁷⁸ See Item 303(a) of Regulation S-K under the Securities Exchange Act of 1934. It should be noted, though, that Item 101 demands a description of the business inclusive of the risk factors it is exposed to.

⁷⁹ SEC Release No. 33-8350; 34-48960 (“Interpretation: Commission Guidance on Management’s Discussion and Analysis of Financial Condition and Results of Operations”), December 29, 2003.

comment letters were sent to filers, seeking amendments to the content of the reports and especially to the insufficient quality of the disclosure included in the MD&A sections.⁸⁰

For the purpose of complementing and enhancing corporate financial statements and management commentaries (i.e. MD&A in the United States and OFR in the United Kingdom), in 2002 the Board of Directors of the American Institute of Certified Public Accountants (AICPA) launched a proposal to establish a collaborative effort among a large number of international stakeholders. In January 2005, the Enhanced Business Reporting (EBR) Consortium was founded as a not-for-profit and independent collaboration of investors, creditors, analysts, management, directors, academics, and standard-setters charged with developing an EBR Framework. The Conference Board Global Corporate Governance Research Center joined the EBR Consortium as a strategic partner in the summer of 2005.⁸¹

On October 18, 2005, a first exposure draft of the EBR Framework was released for comment from the business reporting community.⁸² Its structure includes four new broad categories of extra-financial disclosure:

- Business landscape
- Strategy
- Competencies & resources
- Performance

Each category is then articulated into a number of disclosure items (see box).

The EBR Framework was also devised to permit the use of taxonomies (such as XBRL)⁸³ for the classification of companies on the basis of their value drivers, performance measures, and qualitative information

Enhanced Business Reporting Framework

Level 1	Level 2
Business landscape	Overview Competition Customers Technological change Shareholder relations Capital availability Legal Political Regulatory
Strategy	Business model Organization Governance Risk management Environmental & social Business portfolio Resource allocation Product life cycle
Competencies & resources	Key processes Customer satisfaction People Innovation Supply chain Intellectual property Information & technology Financial assets Physical assets
Performance	Profitability Liquidity Operating Segment

Source: The Enhanced Business Reporting Framework, Exposure Draft, October 2005.

⁸⁰ See "Summary by the Division of Corporation Finance of Significant Issues Addressed in the Review of the Periodic Reports of the Fortune 500 Companies," February 27, 2003, available at <http://www.sec.gov/divisions/corpfin/fortune500rep.htm>.

⁸¹ In addition to the AICPA, the Founding Members of the EBRC are Grant Thornton LLP, Microsoft Corporation and PricewaterhouseCoopers LLP. Other Strategic Partners include: The Business Roundtable, National Association of Corporate Directors and NASDAQ.

⁸² *The Enhanced Business Reporting Framework*, Public Exposure Draft, October 2005. The draft can be downloaded at www.ebr360.org.

⁸³ XBRL stands for eXtensible Business Reporting Language. It is an open standard (free of license fees) for the electronic communication of business and financial data being developed by an international non-profit consortium of approximately 250 major companies, organizations and government agencies. It is already being put to practical use in a number of countries and implementations of XBRL are growing rapidly around the world (an XBRL Voluntary Program was launched by the U.S. SEC in early 2005). In a speech held at the 12th XBRL International Conference in Tokyo on November 7, 2004, SEC Chairman Christopher Cox stated: "Interactive data promises more than simply a revolution in corporate reporting. For the SEC [the XBRL Voluntary Program] is an opportunity to assess how the use of interactive data can help us improve our internal review of information, and how it can help us make it available in more useful form to the public." See www.sec.gov/news/speech/spch110705cc.htm.

Other Initiatives to Reform Business Reporting

Other major initiatives on the enhancement of extra-financial long-term information in business reporting include:

- The International Accounting Standards Board (IASB)'s 2005 Discussion Paper on Management Commentary,⁸⁵ which concludes that the IASB should issue a standard to provide non-mandatory guidance for the disclosure of corporate information on: a) the nature of the business; b) its objectives and strategy; c) its key resources, risks and relationships, d) its results and prospects; and e) its performance measures and indicators.
- The European Union Accounts Modernization Directive of 2003, under which certain public companies listed in EU stock markets are required to include in their annual reports “a balanced and comprehensive analysis of the development and performance of the company’s business and of its position, together with a description of the principal risks and uncertainties that it faces... To the extent necessary

for an understanding of the company’s development, performance or position, the analysis shall include both financial and, where appropriate, non-financial key performance indicators relevant to the particular business, including information relating to environmental and employee matters.”⁸⁶

- The International Organization of Securities Commissions (IOSCO)'s 2003 General Principles Regarding Disclosure of Management’s Discussion and Analysis of Financial Condition and Results of Operations. Although the concept of MD&A outlined in the document does not depart from a commentary of financial results, IOSCO indicates that “care should be taken to avoid the use of boilerplate or stock language that appears to be in technical compliance with disclosure requirements, but that nonetheless fails to provide investors with appropriate information they need to make valuation and investment decisions.”⁸⁷

on strategy and risk. In other words, through EBR, market participants (investors, analysts, etc.) will be able to extract from public filings specific information they need in their evaluation of corporate performance.

“Enhanced Business Reporting can change the markets’ focus on short-term earnings projections,” said Robert Eccles, an advisor to the EBR Consortium and former

Harvard Business School professor who was also among the London Summit delegates. “The over-emphasis on quarterly earnings will decline as companies report transparently on their key drivers of value creation. The long-term rewards will be tangible: a greater investor following, lower stock-price volatility and ultimately a more attractive cost of equity and debt.”⁸⁴

⁸⁴ See the Enhanced Business Reporting Consortium press release of October 18, 2005 (“Enhanced Business Reporting Consortium Releases Framework to Promote Greater Transparency in Corporate Reporting”). Robert Eccles is among the most influential scholars who have been advocating the need to revise the system for the communication of enterprise value drivers. Eccles’ research on reforming corporate reporting is extensive; in addition to the work elsewhere cited in this report, see, for example: “Improving the Corporate Disclosure Process,” *Sloan Management Review* 36 (1995), page 11-25 (with Sarah C. Mavrinac); *Value and Reporting in the Banking Industry*, PricewaterhouseCoopers, 1999 (with John K. Fletcher); and *Value and Reporting in the Insurance Industry*, PricewaterhouseCoopers, 1999 (with Michael P. Nelligan).

⁸⁵ *Discussion Paper. Management Commentary*, International Accounting Standards Board, October 2005, Section 4.100, page 33.

⁸⁶ Article 46(1) of Directive 2003/51/EC of the European Parliament and of the Council of 18 June 2003 amending Directives 78/660/EEC, 83/349/EEC, 86/635/EEC and 91/674/EEC on the annual and consolidated accounts of certain types of companies, banks and other financial institutions and insurance undertakings, *OJ L 178, 17/07/2003* page 16-22.

⁸⁷ *General Principles Regarding Disclosure of Management’s Discussion and Analysis of Financial Condition and Result of Operations*, Report of the Technical Committee of the International Organization of Securities Commissions, February 2003, page 3.

The Impact of Sustainability Issues on Long-Term Performance

More popular in Europe, the thesis relating the impact of corporate governance and sustainability issues to long-term stock return⁸⁸ has traditionally encountered a high degree of skepticism in the U.S. business community. More recently, however, it has been bolstered by a number of empirical studies conducted by international organizations and investment firms.

The UNEP FI Materiality Project

The most notable is the June 2004 report published by the United Nations Environment Programme Finance Initiative (UNEP FI) and entitled *The Materiality of Social, Environmental and Corporate Governance (ESG) Issues to Equity Pricing*. The report summarizes the findings of an 11-sector study conducted by the Asset Management Working Group (AMWG), sponsored by UNEP FI and composed by major brokerage houses based in the United States, Canada, Europe, South Africa, Brazil, and Japan.⁸⁹ Data included in the publication show that long-term protection of shareholder value rests upon the rigorous integration in the corporate strategy of policies on climate change, internal governance and openness to shareholder proposals, innovation and scientific research, labor rights and public health.

The analysis of the pharmaceutical sector, for example, confirmed that there is considerable scope for the development of valuation techniques to quantify the financial value of ESG-based strategic decisions taken by drug makers.⁹⁰ Specifically, Margaret Foran from Pfizer Inc, who was a Summit delegate, commented that the pharmaceutical industry is more receptive to the notion of long-termism. She noted: “the development process of a new medication requires, per se, the ability to expand the company’s horizon and communicate to investors about results that will materialize only ten or twenty years later.” Because investors in the industry are used to this exercise, pharmaceutical companies that not only invest for the long-term but also increase transparency on sustainable projects are likely to be rewarded in the long run.

Similar considerations are applicable to other sectors, such as the utilities and energy industries.⁹¹ Goldman Sachs contributed to the UNEP FI research by developing a set of social and environmental metrics specifically designed

⁸⁸ An extensive body of academic work explores the correlation between corporate governance provisions (specifically, those identified by the Washington-based Investor Responsibility Research Center) and long-term shareholder value. Early analyses were limited to single provisions (for example, those contained in anti-takeover statutes, on poison pills and staggered boards). See Jonathan M. Karpoff and Paul H. Malatesta, “The Wealth Effects of Second-Generation State Takeover Legislation,” *Journal of Financial Economics*, Volume 25 (1989), page 291-322; Mick Swartz, “The Massachusetts Classified Board Law,” *Journal of Law, Economics and Organization*, Volume 22 (1998), page 29. For a broader overview of this early production, see Grant Gartman, “State Antitakeover Law,” Investor Responsibility Research Center, Washington, DC, 2000. See the box “On the Link Between Corporate Governance and Performance” for references to a second generation of research attempts to evaluate the incidence on firm value of a variety of governance provisions in the aggregate.

⁸⁹ The Asset Management Working Group participants were: Acuity Investment Management (Canada), BNP Paribas Asset Management (France), Calvert Group Ltd. (USA), Citigroup Asset Management (USA), Groupama Asset Management (France), Morley Fund Management (United Kingdom), Nikko Asset Management (Japan), Old Mutual Asset Managers (South Africa), San Paolo IMI Asset Management (Italy), Storebrand Investments (Norway), ABN Amro Asset Management (Brazil) and HSBC Asset Management Europe.

⁹⁰ Benjamin Yeoh, *Pharmaceuticals and SRI*, ABN AMRO Equities United Kingdom, February 2004: “The current business model revolves around discovering drugs for commercial diseases, trying to commercialize them as quickly and efficiently as possible with the minimum amount of drop outs and then selling them under the protection of a patent for as long as possible. Given the links between minimizing corporate social responsibility and minimizing business risks, we think moving towards accountability on the triple bottom line will make better companies and, it is hoped, a better world.”

⁹¹ Instead, the study done for other sectors (such as apparel) was “unable to conclude that there is a link between the shares’ ratings and the level of compliance with good corporate citizenship.” See Craig Sorour and Thathisihlalo Makunga, “No evidence to link share ratings with good corporate citizenship... yet,” Deutsche Securities, January 14, 2004.

for the energy sector. Such an evaluation methodology was then applied to ESG information voluntarily disclosed by issuers in their annual reports, and resulted in the positioning of energy companies along a four-tier index. In the index, BP and Shell stand out together with ExxonMobil in the first tier, while Yukos and other emerging market regionals are at the bottom due to their very limited disclosure. In its conclusion, the Goldman Sachs paper stresses the importance for executives and directors in the oil industry to have a long-term vision. In order to succeed consistently in gaining a dominant position in new projects, “a company needs to manage not only the traditional oil industry skills but also a diverse workforce in a socially responsible and acceptable manner, *with a vision of the evolution of the industry towards the age of gas.*”⁹²

As for the utilities sector, the commitment to renewable energy required by the Kyoto agreement (ratified by the European Union) and the EU Emission Trading Directive has expanded the strategic view of European utilities. According to the author of a HSBC Asset Management Europe report on this subject: “it is becoming increasingly clear that sustainable development will be one of the major drivers of industrial change over the next fifty years and that there is growing demand from both companies and institutional investors to understand its financial impacts.”⁹³ Although not bound by the same strict emission reduction requirements which apply to European companies, some U.S. competitors are following suit. The Ecoimagination initiative adopted by General Electric to highlight the long-term and sustainable strategic synergies among the businesses that compose its conglomerate is a well-publicized example of how companies, even in the United States, are being persuaded of the business case for ESG/strategy integration.⁹⁴

⁹² Anthony Ling et al., *Global Energy. Introducing the Goldman Sachs Energy Environmental and Social Index*, Goldman Sachs, December 15, 2003. Emphasis added.

⁹³ Colin Monks, Jonathan Yee et al., *European Utilities Pathfinder II*, HSBC Asset Management Europe, September 2003.

The Deutsche Bank Corporate Governance Framework

The argument about the materiality of rigorous standards of corporate governance on long-term firm value is convincingly supported in the *Beyond the Numbers* series of publications sponsored by Deutsche Bank (DB). Members of the Global Equity Unity at the investment firm have developed a framework to:

- analyze key corporate governance issues across countries;
- explore the relationship between those standards and stock market risk (e.g. volatility);
- quantify the impact of the key corporate governance standards on firm profitability, firm evaluation, and stock performance; and
- systematically integrate those standards and their metrics into the portfolio management process adopted by investors.

Upon the application of the framework to companies in the S&P 500 and the FTSE 1000 indexes, researchers at DB found that “corporate governance standards are an important component of equity risk” and that—aside from the differences in the legal and regulatory structures—“it is ultimately the company itself that decides what level of transparency and rights it provides to shareholders. This is particularly the case for companies willing to attract global investors into their shareholder base.”⁹⁵

⁹⁴ The company’s May 9, 2005 press release reads as follows: “General Electric Company Chairman and CEO Jeff Immelt today announced Ecomagination, a GE initiative to aggressively bring to market new technologies that will help customers meet pressing environmental challenges. ‘Ecomagination is GE’s commitment to address challenges such as the need for cleaner, more efficient sources of energy, reduced emissions and abundant sources of clean water,’ Immelt said. ‘And we plan to make money doing it. Increasingly for business, ‘green’ is green.’”

⁹⁵ Renato Grandmont, Gavin Grant and Flavia Silva, *Beyond the Numbers – Corporate Governance: Implication for Investors*, Global Equity Research, Deutsche Bank AG, April 1 2004, p.6. Emphasis added. In addition to the United States and the United Kingdom, the report covers several emerging markets (Eastern Europe, South Africa, Brazil and Argentina, among others). Also see Gavin Grant, *Beyond the Numbers – Corporate Governance in Europe*, March 4, 2005, *Beyond the Numbers – Corporate Governance in Asia and Australia*, March 3, 2006, for the application of the same methodology to companies based in the European Union or in the Far East.

On the Link Between Corporate Governance and Performance

In the long term, a high-quality corporate governance structure may translate into a meaningful shareholder value increase, since it provides a competitive advantage in the global equity marketplace and insures investors against unanticipated risks of corporate fraud. Additional empirical evidence supports this proposition. The most convincing includes:

Governance-ranking research, based on tracking the performance of companies scoring high on major governance rating systems (i.e. IRRC corporate governance provisions or ISS Corporate Governance Quotient (CGQ)). Early analyses proved inconclusive, as they were limited to single governance provisions (for example, those contained in anti-takeover statutes, on poison pills, and staggered boards). Instead, a second generation of studies evaluates the correlation between firm value and a broad variety of governance provisions in the aggregate. For instance, in 2004 the U.S.-based institute GovernanceMetrics International looked at the performance indicators over a 10-year period of 2,100 companies rated on the basis of 450 governance factors, and found a high degree of governance-to-performance correlation for the

top 10 percentile of the surveyed population; specifically, shareholder return appeared higher for companies with an independent board structure and equal voting rights mechanisms for shareholders.⁹⁶

Research based on focus lists (such as the list maintained by CalPERS to publicize companies with major corporate governance failings) or the performance of shareholder engagement funds (i.e. active funds interested in addressing weaknesses in the strategy, governance or financial structure of their portfolio companies). Specifically, over the last ten years Wilshire Associates consultants have been expanding and updating a study on the so-called “CalPERS Effect.” The latest edition examined the performance of 113 companies targeted by CalPERS between 1987 and 2003; results indicate that while stock of these companies trailed the Standard & Poor’s 500 Index by 97.7 percent in the 5-year period before CalPERS acted, the same stocks outperformed the index by 8.1 percent in the following five years.⁹⁷

Recommendations for the Financial Services Industry

The United Nations Global Compact, an initiative of the UN Secretary-General, is also actively working with financial services sector professionals, governments and other stakeholders to promote the integration of ESG issues into mainstream financial markets. A number of influential institutions accepted the invitation to participate in the *Who Cares Wins* project and developed 22 recommendations for investment decisions that fully take into account sustainability and corporate governance factors.

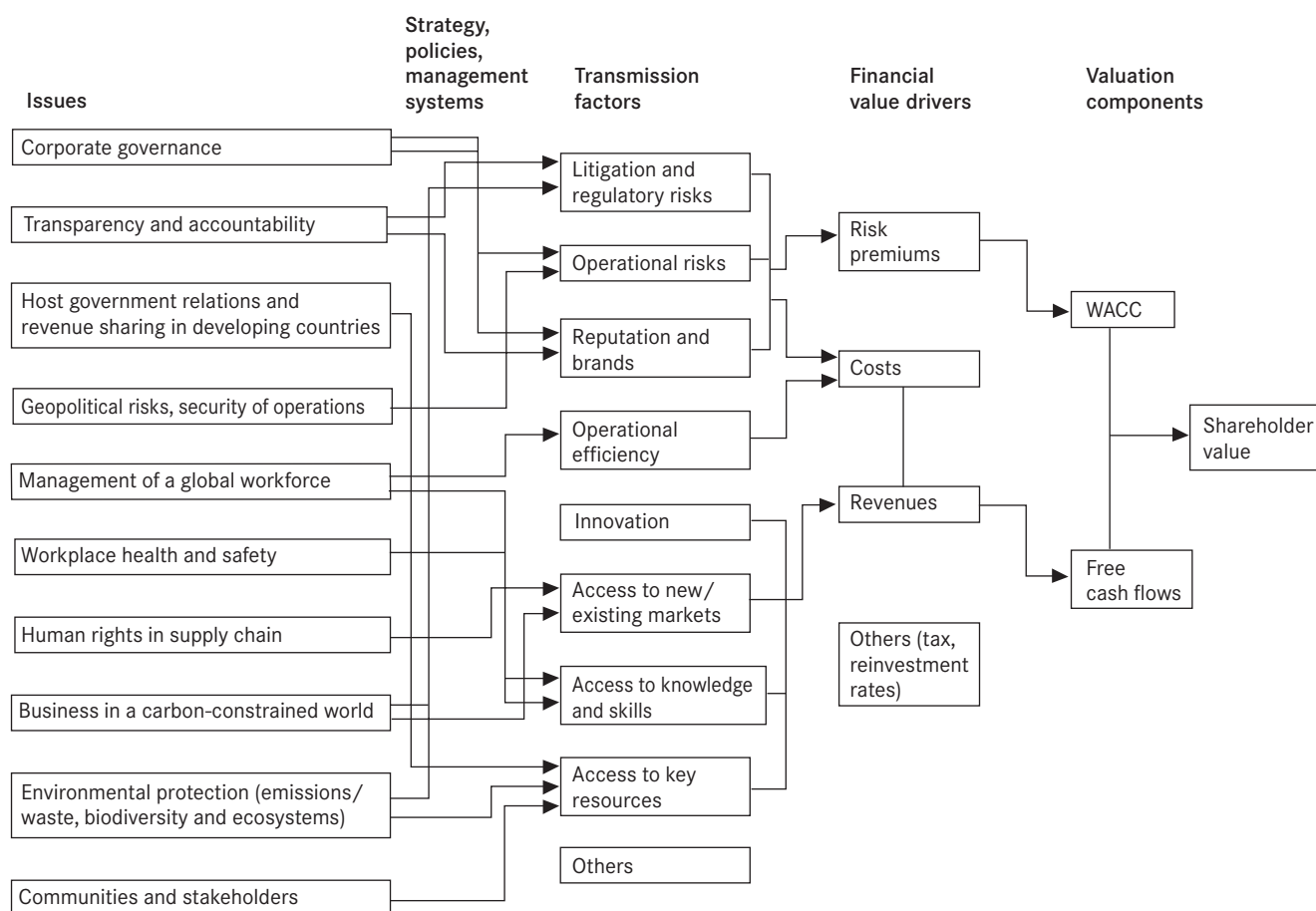
The *Who Cares Wins* report, published in August 2004, urges investors: “to explicitly request and reward research that includes ESG aspects and to reward well managed companies. Asset managers are asked to integrate research on such aspects in investment decisions and to encourage brokers and companies to provide better research and information. Both investors and asset managers should develop and communicate proxy voting strategies on ESG issues, as this will support analysts and fund managers in producing relevant research and services.”⁹⁸

⁹⁶ See: *GMI Governance and Performance Analysis*, GovernanceMetrics International, March, 2004. For other findings on the correlation, see: Lucian Bebchuk, Alma Cohen and Alan Ferrell, “What Matters in Corporate Governance?,” *2005 Harvard Law School Discussion Paper* No. 491; and Paul Gompers, Joy Ishii and Andrew Metrick, “Corporate Governance and Equity Prices,” *Quarterly Journal of Economics*, Volume 118 (2003), page 107-155.

⁹⁷ See: John Noh, *The ‘CalPERS Effect’ on Targeted Company Share Prices*, Wilshire Associates, July, 27, 2004. On the CalPERS Effect, also see: Mark Anson et al., “The Shareholder Wealth Effects of CalPERS’ Focus List,” in *Journal of Applied Corporate Finance*, Vol, 15 (2003), No.3, pp. 8-17.

⁹⁸ *Who Cares Wins. Connecting Financial Markets to a Changing World. Recommendations by the Financial Industry on How to Better Integrate Environmental, Social and Governance Issues in Analysis, Asset Management and Securities Brokerage*, United Nations The Global Compact, August 2004, page iii and page 22, available at <http://www.unglobalcompact.org/content/NewsDocs/WhoCaresWins.pdf>. 20 financial institutions from 9 countries with total assets under management of over 6 trillion USD have participated in developing this report. Funding for the project was supported by the Swiss government.

Figure 2
Application to the energy sector of The Conference Board's framework for integration of ESG factors



Source: *Expanding the Investment Frontier. Factoring Environmental, Social, and Governance Criteria into Investment Analysis*, The Conference Board, Research Report 1378-05-WG, 2005.

The Conference Board has been among the partners in the project since its inception. In fact, in response to the need evidenced by the *Who Cares Wins* publication, The Conference Board convened a Working Group to develop a methodological framework to help market participants identify ESG factors relevant to 10 sectors and evaluate their potential significance for individual

companies. The resulting framework, based on a standard discounted cash flow model, was released with the November 2005 Conference Board research report entitled *Expanding the Investment Frontier*.⁹⁹ The framework is supported by one example of practical application to the energy sector (see Figure 2).

⁹⁹ Charles J. Bennett, Ivo Knoepfel and David J. Vidal, *Expanding the Investment Frontier. Factoring Environmental, Social, and Governance Criteria into Investment Analysis*, The Conference Board, Research Report 1378-05-WG, 2005.

Restructuring the Securities Research Industry

Summit delegates agreed that, no matter what actions are taken by corporations to develop extra-financial performance indicators and by investors to expand their investment horizons, the short-termism chain will only be broken if securities analysts (which represent the intermediary link of the chain) are also involved in the process.

Searching for a New Business Model

Summit delegates agreed that quarterly earnings do not reflect companies' long-term viability and provide an incomplete picture of their health. Earnings-per-share ratios are, therefore, a highly inaccurate measure of sustainable performance and growth. In a speech given at the May 2005 CFA Institute Annual Conference, in Philadelphia, former SEC Chairman William H. Donaldson addressed the challenge for financial analysts to move beyond market short-termism. Specifically, he stressed how the quality of securities research is “critical to determining the long-term cost of capital, and to measuring the vitality of our markets and our economy.”

In 2004, two major international financial institutions announced the reorganization of their research businesses. After merging its equity and debt market platforms under a single management just a few months earlier, Deutsche Bank fired three of its most senior equity research heads as a first step towards a fully-fledged integration of the bank's equity and fixed income research teams. More radically, Credit Suisse responded with the layoff of an entire research unit to the reputational damage it suffered from the SEC investigation and legal proceeding on the entanglement between financial analysis services and investment banking activities.

To be sure, the sell-side securities research industry is nowadays facing a major challenge that reaches the core of its business model. The costs to staff a top-tier global equity research department is estimated at about \$300 million a year.¹⁰⁰ On the other hand, research is

a low-margin product and its profitability has been shrinking even further under recent pressures from regulators and the investment community.

In the last few years, the U.S. Congress, the SEC, the European Commission, and other regulators have addressed the conflict of interest affecting the preparation and dissemination of sell-side research by large financial service firms. Section 501 of the Sarbanes-Oxley Act requires national stock exchanges to have in place a set of rules designed to foster greater public confidence in securities research and protect the objectivity and independence of securities analysts, by:

- Restricting the prepublication clearance or approval of research reports by persons employed by the broker or dealer who are engaged in investment banking activities or are not directly responsible for investment research.
- Limiting the supervision and compensatory evaluation of securities analysts to officials employed by the broker or dealer who are not engaged in investment banking activities.
- Requiring the definition of periods during which the brokerage firm participating in a public offering of securities as underwriter or dealer should not publish or otherwise distribute research reports related to securities or its issuer.
- Requiring the establishment of structural and institutional safeguards within the financial firms to assure that securities analysts are separated by a series of Chinese walls and other informational partitions from the review, pressure, or oversight of those whose involvement in investment banking activities might potentially bias the analysts' judgment.
- Strengthening disclosure requirements on potential conflict of interests between research professional and investment bankers employed by the same brokerage firm.¹⁰¹

Similar structural barriers intended to prevent internal conflicts of interest are being established in the European Union under the Market Abuse Directives enacted in 2003.

¹⁰⁰ “Lex: Equity Research,” *Financial Times*, November 28, 2004.

Specifically, “Member States shall require disclosure, in general terms, of the effective organizational and administrative arrangements set up within the investment firm or the credit institution for the prevention and avoidance of conflicts of interest with respect to recommendations, including information barriers.”¹⁰²

In addition, on December 28, 2003, the New York State Attorney General Eliot Spitzer (together with the SEC, the major U.S. stock exchanges, and state securities regulators) announced the end of their formal investigation into research analyst market practices and the successful negotiation of a Global Settlement with ten leading securities firms.¹⁰³ Under the terms of the final agreement, each of the ten firms accepted to abide by significant organizational restrictions intended to separate research and investment banking functions, and to contract with independent research providers to corroborate their investment recommendations to customers. The impact of the settlement on the industry was such that many smaller broker-dealers have then voluntarily adopted at least some of the described restrictions.

What is certain is that, as a result of the new regulatory regimes and the Global Settlement, those costly research units can no longer be subsidized by the more lucrative services (i.e. financial assistance, securities underwriting and placement services, deal management, etc.) offered by financial institutions. In order to be able to continue their securities research operations, brokers and dealers are therefore forced to probe into their business model and demonstrate their commercial value to the market.

Enhancing Securities Analysis

In the current business climate, return from investment is far from a certainty, even for those players (such as hedge funds) that strategically pursue short-term speculative opportunities. Disappointed by the guidance received from securities analysts and forced to curb costs that impact their bottom lines, an increasing number of institutional investors are questioning the value added by financial research. In some cases, fund managers have cut the commissions paid to brokerage firms for their sell-side research services. In others, those firms were even brought to court on the ground that, because of their inability or unwillingness to fully understand accounting techniques, they also should be held responsible of the numerous episodes of fraud and malfeasance by corporate managers. In any case, investors are becoming very sensitive to the content of the financial analyses they purchase. “We are now paying much more attention to high quality, objective, and comprehensive financial research that can truly help us build a durable portfolio,” stated a Summit participant representing a major investment fund.

¹⁰¹ As for the rules adopted under Section 501 of the Sarbanes-Oxley Act by the NYSE and Nasdaq, see NYSE Rule 472 (Communications with the Public), NYSE Rule 351 (Reporting Requirements), and NASD Conduct Rule 2711 (Research Analysts and Research Reports). The new rules were approved by the SEC on July 29, 2003; see SEC Release No. 34-48252 (“Self-Regulatory Organizations; Order Approving Proposed Rule Changes by the New York Stock Exchange and the National Association of Securities Dealers Relating to Research Analyst Conflict of Interest”), July 29, 2003. On the so-called Research Rules, see the joint NYSE/NASD commentary entitled *Discussion and Interpretation of Rules Governing Research Analysts and Research Reports*, 2003.

¹⁰² Article 6.2 of the European Commission Directive 2003/125/EC, December 22 2003, implementing Directive 2003/6/EC of the European Parliament and of the Council on the fair presentation of investment recommendations and the disclosure of conflicts of interest. Also, “Member States shall ensure that there is appropriate regulation in place to ensure that relevant persons disclose all relationships and circumstances that may reasonably be expected to impair the objectivity of the recommendation, in particular where relevant persons have a significant financial interest in one or more of the financial instruments which are the subject of the recommendation, or a significant conflict of interest with respect to an issuer to which the recommendation relates” (Article 6.1). Finally, “Member States shall require that for natural or legal persons working for an investment firm or a credit institution, under a contract of employment or otherwise, and who were involved in preparing the recommendation, the requirement (...) shall include, in particular, disclosure of whether the remuneration of such persons is tied to investment banking transactions performed by the investment firm or credit institution or any related legal person” (Article 6.3). The directive is published in OJ L 339 of December 24, 2003, pages 73-77.

¹⁰³ See SEC Release No. 2003-54 (“Ten of Nation’s Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking”), April 28, 2003. The settlement was ratified by the U.S. District Court for the Southern District of New York on October 31, 2003. A set of documents related to the Global Research Analyst Settlement can be downloaded from the SEC website at www.sec.gov/spotlight/globalsettlement.htm. The ten settling firms are: Bear, Sterns & Co. Inc.; Credit Suisse First Boston LLC; Goldman Sachs & Co.; Lehman Brothers Inc.; J.P. Morgan Securities Inc.; Merrill Lynch, Pierce, Fenner & Smith, Incorporated; Morgan Stanley & Co. Incorporated; Citigroup Global Markets Inc.; UBS Warburg LLC; and U.S. Bancorp Piper Jaffray Inc.

The response of the financial service industry to regulatory pressures and investors' demand for reform varied from firm to firm. Some closed or downsized their research business; others outsourced it to external independent houses. Those who decided to stay in the business are now attempting to customize their product and address specific research needs of investment funds and other clients. Although the process remains slow, customized products are being developed to supply sustainability-based research to long-term public pension funds and members of the recently formed, ground-breaking Enhanced Analytics Initiative (see box below).

Among the investment firms that have made a commitment to support enhanced securities research are:

BNP Paribas Asset Management (France), Hermes Pension Management Ltd. (United Kingdom), PGGM (The Netherlands), The Mistra Foundation (Sweden), and Universities Superannuation Scheme (UK).

As recently as December 2005, Stichting Pensioenfonds ABP (ABP), the Dutch civil service pension fund, and BT Pension Scheme (BTPS), one of the UK's largest pension schemes, have both joined the Enhanced Analytics Initiative, whose total assets under management have exceeded Euro 656 billion. A statement released by ABP comments upon their decision to join as follows: "ABP believes that companies with the best sustainable strategies, which encompass financial, social, environmental and corporate governance factors, will deliver

The Enhanced Analytics Initiative

The Enhanced Analytics Initiative is a landmark group of asset owners and fund managers who have agreed to allocate a minimum of five percent of broker commissions to long-term securities analysis that effectively incorporates extra-financial measures of performance and corporate intangibles.

The goal is to generate "a commercial incentive [for brokers] to produce research that captures the risks and rewards related to corporate performance on extra-financial issues. In doing so, brokers will be better meeting the real needs of long-term investors and their clients/matters... Research resulting from [the] project will simply provide buy-side analysts and portfolio managers with a more complete view of investment risks and opportunities by better analyzing a more complete set of drivers of company performance. The outcome should be less divergence between market prices and true fair value."

"EAI members believe this research will add value to both asset managers and asset owners by:

- identifying brokers that are most dynamic in providing differentiated research that helps generating alpha;
- providing investment insight relevant for mandates which have a fundamental research approach or who have absolute risks/returns or unconstrained mandates;
- providing investment ideas for managers looking to short stocks on the basis of the market not pricing in risk which can be anticipated;
- providing the research which would allow more objective prioritization of engagement activity with companies (i.e. for those investors who adopt an active owner perspective);
- ensuring corporate executives are challenged on a more complete set of issues which drive risk and reward, and so reducing the tendency for investment professionals to inadvertently encourage a damaging focus on short-term share price movements."

"What the buy side does with this research is entirely up to each fund manager to decide. Where it doesn't add value, managers will ignore this data as they do with other research inputs that don't add value to a particular investment decision."

As EAI membership currently stands, the allocated five percent of broker commissions is equivalent of 9 million euros.

Source: www.enhanced-analytics.com

the best long-term performance. Therefore we consider it essential to integrate extra-financial information throughout our mainstream investment process. The difficulty is that while progress is being made, good quality data and research on extra-financial issues are still broadly lacking and, as a result, ABP decided to ... actively support better investment research.”¹⁰⁴

Young Analysts as Key Agents of Change

While securities firms are becoming more receptive to the need for reform, a cultural resistance on the part of professionals appears as the major obstacle to any attempt at breaking the analyst link of the short-termism chain. In fact, despite increasing evidence for the materiality of environmental, social, and corporate governance (ESG) factors to the fair value of securities, a study sponsored by UNEP Finance Initiative and the World Business Council for Sustainable Development indicates that such issues are at best a peripheral concern for young financial analysts.¹⁰⁵

A number of interviews with junior professionals representing a broad range of securities research houses revealed that they remain:

- Typically uninformed on many ESG issues and other long-term sustainability concepts;
- Unsure about how ESG and sustainable goal could be achieved;
- Skeptical about their actual impact on share prices;
- Reluctant to learn of new methodologies to differentiate their analytical skills and factor sustainability issues into their research conclusions;
- Unconvinced of the demand for such research from their client; and therefore
- Doubtful that their employers would reward them for producing research recommendations based on companies’ ESG policies and sustainable strategies.

The motivation for this research project is illuminating, and confirms the widespread consensus on the need for a concerted change that permeated our Summit discussion. In fact, the study was conducted “in the belief that financial analysis can be a significant enabler or inhibitor of change in corporate practice, and that young analysts may be key agents of change within financial institutions.”

By discussing the interplay among the links in the short-term chain, Summit delegates could identify a number of trends pertaining to:

- the increasing use by corporations of long-term financial and non-financial indicators of performance;
- the need for a balanced set of incentives for managers to pursue long-term objectives measurable through such indicators;
- the adoption of effective methodologies for the communication of such information to the markets;
- the willingness of certain investors to act on such long-term financial and extra-financial information; and
- the reorganization of the securities analysis industry through the development of long-term sustainable research products.

In the final part of the London Summit, delegates were asked to advance ideas for action which The Conference Board could further explore.

¹⁰⁵ See *Reality Check. Young Financial Analysts’ Views on Environmental, Social and Corporate Governance Issues*, United Nations Environment Programme Finance Initiative–World Business Council for Sustainable Development (Young Managers Team), Geneva, January 2005. Participants in the study were financial analysts under 35 years of age and a minimum of three years of relevant professional experience. The sample was chosen among sell-side financial services professionals based in continental Europe, the UK, Hong Kong, and the US. The survey mainly focused on researchers from mainstream investment banks and dedicated research houses, but also included a few representatives from large institutional investors, private banking for high net-worth individuals, and specialist SRI research houses. Sectors covered encompass the new economy (e.g. technology, telecoms, and media), the financial services area and those industries that have traditionally been more receptive of the ESG discourse (such as aerospace and defense, energy, and pharmaceuticals). The findings were discussed at an Expert Roundtable in New York in March 2005, and further analyzed in *Generation Lost: Young Financial Analysts and Environmental, Social and Governance Issues*, July 2005.

¹⁰⁴ See the Enhanced Analytics December Newsletter, available at www.enhancedanalytics.com. On the contribution that pension funds and large asset owners may offer to promote long-term investing, also see The Marathon Club, *Long-Term Long-Only Investing: A Consultation Paper*, March 2006.

Summit Delegates' Suggestions for

Future Action

By convening some of the most distinguished representatives of the corporate and investment worlds, as well as other recognized experts in the field, the July 2005 London Corporate/Investor Summit intended to serve as a “reality check” on the stock market short-termism issue.

Summit delegates clearly felt recent events have exposed the urgent need to address a problem with major economic implications on today’s globalizing economies. On a macro-economic level, short-term visions are the cause for market volatility and the instability of financial institutions. From the micro-economic standpoint, they undermine management continuity and expose a public company to the risk of losing sight of its strategic business model, compromising its competitiveness. In addition, the pressure to meet short-term numbers may induce senior managers to search for a number of business costs (i.e. the cost of a state-of-the-art pollution control system) to externalize, often to the detriment of the environment and future generations.

More recently, short-termism has been accentuated by speculative factors and, in certain cases, less than desirable business ethics practices. However, the last decade has also seen encouraging changes in the way the financial system works. As a result of the financial scandals that enmeshed the corporate world both in Europe and the United States, public institutions as well as self-regulatory business organizations are more alert; in particular, they are aware that market confidence can slip away where fiduciary behavioral standards are dubious or lack the proper enforcement.

Institutional investors are empowered by regulatory regimes that have increasingly recognized their role as active shareholders and corporate monitors. The sensitivity of the public to excessive compensation and the performance accountability issue is unprecedented. Corporate reporting is also being revolutionized, and initiatives abound to develop an innovative system of disclosure aligned with the intangible nature of modern corporate assets.

The debate on long-term sustainable performance is gaining ground, supported by new empirical findings that reveal how environmental and social projects may in fact provide valuable business opportunities. Finally, the securities research sector is in turmoil, as financial institutions are forced to reconsider their business models, prove the commercial value of the research product, and depart from financial analyses based overwhelmingly on less than adequate short-term indicators.

A few Summit delegates used the word “chain” to describe a phenomenon for which all corporate and financial market participants should bear some degree of responsibility. The chain of short-termism has three major links:

- **the corporate link**
- **the investor link**
- **the analyst link.**

Any attempt at tackling the issue from a single front is destined to fail; for the problem to be adequately addressed, each link should be unlocked in a concerted and collective fashion.

By building on the discussion held at the London Summit, The Conference Board Global Corporate Governance Research Center intends to further the dialogue among corporate executives, fund managers and financial researchers so as to facilitate a mutually beneficial and collective effort. The following are the Summit Delegates' suggestions for future action and research in the field.

Unlocking the Corporate Link

- **Further studies should be undertaken regarding the deployment of intangible assets. Research should be diversified by type of industry and geographical region, so as to develop a set of sector-specific financial and extra-financial performance metrics.**

Such metrics could then be embraced and disseminated by business associations, encouraging their “best practices” implementation by the leading companies in the industry or fostering the development of sector-based voluntary frameworks for extra-financial reporting. Geographical diversification of research would improve the understanding of the interplay between intangibles and corporate cultures, so as to address those cultural shortcomings that may limit the optimal use of business assets. As performance metrics are better identified, a related body of research on the negotiation of compensation schemes tied to performance may be furthered.

- **Proposed disclosure frameworks to enhance corporate transparency on intangible assets and extra-financial measures of performance should be supported by empirical research on their application.** As noted in this report, a number of frameworks are being developed. Although these proposals come from public or not-for-profit institutions, the competition among sponsoring organizations may generate confusion and undermine their credibility. Moreover, in the currently overregulated securities markets, any attempt at expanding reporting requirements may encounter the resistance of business lobbying groups, which fiercely oppose imposing any extra cost of compliance. A reliable set of data on the market appreciation for the practical use of a certain framework would therefore facilitate the natural selection of one “best practices” model and encourage its widespread adoption.

- **Research on intangible assets and extra-financial measures of performance should be based on voluntary trial programs where, in addition to filing their regular annual reports, participating companies provide financial analysts and large investors with a more comprehensive set of information on their value drivers.** Comparative information on how the response from investors and analysts varies according to the report they read would be very helpful to assess the quality of the proposed “best practices” framework. Should the Operating and Financial Review requirement (or an alternative standard of enhanced disclosure) be adopted, the experience from its implementation to quoted companies in the United Kingdom will also be valuable and add important knowledge to this subject.
- **Widespread adoption of an enterprise risk management (ERM) framework should be encouraged as an effective process to assess and respond to strategic and operating risks is crucial, not only to bring clarity to the long-term strategic direction a business should take, but also to clearly communicate such long-term strategy to the market.** Risk assessment and management is intimately connected with the development of a sound long-term strategy. In the United States, the case for the corporate board's duty to oversee the development of a rigorous set of risk management procedures rests on an expanding legal framework (inclusive of Delaware case law on the duty of good faith, federal legislation such as the Sarbanes-Oxley Act of 2002 and national exchange listing standards). Moreover, institutional investors and rating agencies are increasingly paying attention to how corporations manage their strategic and operating risks, as risk management is seen as a fundamental element of good governance. Therefore, it is important that board members and senior executives perceive ERM not as a costly compliance exercise to be suspicious of, but as a strategic effort that will set the company apart from its competitors. The Conference Board has undertaken a series of empirical research projects in the area of ERM and is committed to disseminate further knowledge on this subject.

Unlocking the Investor Link

- **Pension fund trustees should develop internal governance practices consistent with a long-termism investment outlook.** Specifically, public and private pension funds and asset managers should investigate how they can best:
 - ensure that any investment managers they utilize are trained to use long-term metrics in the selection of investment opportunities;
 - ensure transparency regarding their rationale for the use of certain metrics in a specific investment choice; and
 - establish incentives so that fund managers become the facilitators of a dialogue with business senior executives and directors meant to further long-term corporate performance.

Research on institutional investor governance is scarce. Practices in this area should be better identified, initially through surveys and opinion-based research of pension fund managers (traditionally, the most activist and long-term). Subsequently, a group of leading institutions committed to this cause could design a set of high-level “best practices” principles to be disseminated in the investment community.

- **The transition from antagonism to engagement of certain long-term investors—especially regarding long-term strategic discussions—should be fully explored.** Cases should be identified where companies have successfully discussed their long-term strategies with investors and where those investors have acted to support these long-term strategies by eschewing the lure of short-term price fluctuations. Such positive engagement experiences could become a source of inspiration for other smaller investors. Also, they would persuade companies of the business case not only for developing financial and extra-financial performance measurement systems, but also for taking their investor relations to a higher, strategic level (which includes devising new channels of communications with investors regarding their long-term objectives).

- **Additional legal research would help understand the extent to which an investment manager may push for a long-term strategic agenda consistent with observing his fiduciary duties.** Can institutional investors help break the short-termism chain without violating their legal responsibilities? Among the main objections raised to activists is that fiduciary duties require asset managers to stay away from long-term investment decisions whose financial return is not clearly assessable. Recently, an international study sponsored by the United Nations and entitled A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment revealed that, on the contrary, most jurisdictions in the world do not support a single-minded pursuit of profit maximization by asset managers.
- **The motivations for the activism of hedge funds and other alternative investment vehicles should be investigated to ensure that their impact on certain market trends (i.e. short-termism versus long-termism) is fully understood.** In a changing investment environment, the role of hedge funds is clearly under transformation. Specifically, as larger and larger amounts of financial assets are being allocated to alternative investment strategies, hedge funds may acquire the status of corporate activists. Recently approved hedge fund regulation in the United States may also grant them new forms of recognition in the marketplace.

Unlocking the Analyst Link

- **Studies should be promoted to identify a viable business model to profit from the sale of high-quality investment analysis of how to build a durable, long-term portfolio.** A number of securities firms have distanced themselves from short-term investment research. As the market increasingly questions the value of securities research based almost exclusively on EPS and other short-term results, customized research products embedding the analysis of extra-financial measures of performance are being offered to better serve investors. Once available only as specialist advice for a niche market comprised of socially responsible investment funds, corporate CSR departments or shareholder engagement companies, long-term sustainability analysis is gaining more recognition and becoming of interest to a broader class of asset managers.

Nonetheless, securities research remains a low-margin business and a new, more viable business model needs to be investigated. It would be essential for the analyst community to share any knowledge and successful experience on this delicate transition phase for the securities research business

- **Bold efforts undertaken by the UNEP, the Enhanced Analytics Initiative, and the CFA Institute should be reinforced to develop a new cadre of securities analysts and financial intermediaries focused on long-term corporate valuation.** Even though securities firms are becoming more receptive to the need for reform of their investment research business, the recent UNEP FI survey entitled *Generation Lost: Young Financial Analysts and Environmental, Social and Governance Issues* indicates that young financial analysts remain uninformed or unconvinced of the market demand for long-term sustainability research. A concerted effort is therefore necessary to establish a community of leaders in the field of durable extra-financial securities analysis. Young professionals open to reconsider their analytical methodologies should be identified. Opportunities for them to communicate and be mentored by the thought-leaders in the field should be created so as to correct shortcomings in the professional development of the new generations and mainstream such a revised approach to investment research. Trial programs of this sort could be conducted through supportive securities firms (i.e. the members of the Enhanced Analytics Initiative) and professional associations (i.e. the CFA Institute or the AICPA). Empirical findings from such programs would document any progress made in fostering a cultural change that is fundamental to break the analyst link of the short-termism chain.

- **Enterprise risk management (ERM) frameworks should include a set of enterprise-wide procedures to better communicate extra-financial indicators of performance to the investment research community.** Communication procedures should avail of new technologies, experienced investor relation professionals, and a modern concept of the corporation as a nexus of information flows among stakeholders. Communication procedures would then become complementary to periodic corporate reporting. By adding quality to the information supply chain, they would help nurture the forward-looking relationship with investment analysts as well as expand the coverage that the issuer's securities receive in the marketplace. Through expanded coverage, management would be less dependent on the positive short-term recommendations of certain research professionals. Corporate and securities researchers would surely benefit from an attempt at identifying and documenting best practices on how such communication procedures can be embedded in an enterprise-wide risk management framework.

Conclusion

Future Corporate/Investor Summits will be conducted by The Conference Board Global Corporate Governance Research Center to further explore certain of the sub-areas discussed in London. The July 2005 Summit showed a strong consensus about the need to change the current stock market's focus on short-termism. It was also clear that change can only be accomplished through a concerted and interrelated effort by market participants, undertaken simultaneously on the many levels identified in this report.

The Conference Board

Global Corporate Governance Research Center (GCGRC)

Founded in 1993, the GCGRC helps corporations improve their governance processes, inspire public confidence, and facilitate capital formation. In small groups, we bring together corporate executives from leading companies with influential institutional investors. This unique, non-adversarial setting fosters a free-flowing exchange of ideas and concerns.

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Draws on The Conference Board's decade-long reputation as an impartial and authoritative source of corporate governance best practices. It was launched in response to corporate directors' need for a non-academic, impartial forum for open dialogue about the real-world business challenges they face. Practical, time-efficient programs ensure corporate directors stay abreast of trends in governance and meet the challenges of their unprecedented responsibility and accountability.

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