On becoming an activist board!
Sketch of a corporate governance that creates value.

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The governance reforms carried out in publicly traded companies since, if not before, the fiascos called Enron, WorldCom, Tyco, Global Crossing, *et alia* have resulted in boards of directors largely staffed with independent, diligent people with solid business experience.

Then, why is it that boards, though dutiful and careful, remain surprise-prone and ill-equipped to challenge management. How can we explain the governance issues manifested in so many corporations? Indeed, if management does ***not*** provide the board with the relevant information, hides from the board or lies to the board, how can the board be held accountable?

Yet, in most, if not all, fiascos, in hindsight, it appeared that warning signs had been overlooked by the board, red flags unseen, symptoms unattended, vagueness not probed.

Boards in the dark

The Lehman bankruptcy some five years ago offers a stark illustration of this phenomenon. In his report (in 9 volumes and over 2, 200 pages), the court-appointed Examiner finds no actionable fault ("colorable claim" in the American legal jargon) against the board of directors of Lehman.

At the time of its bankruptcy, Lehman's board was, typically, made up of retired CEOs of large industrial companies unrelated to the Lehman business (IBM, GlaxoSmithKline, Haliburton, Telemundo Group, Sotheby's), a theatrical producer, the former CEO of the American Red Cross, a couple of long-serving members, and the recent arrival (April 2008) of a former executive from the financial sector.

The board did what it could; board members exercised their business judgment, a judgment shaped by an experience totally foreign to the investment banking/trader business in the years 2000-2008. They made decisions on the basis of their limited knowledge of the financial business and the information management provided and carefully managed.

For the board meeting of March 20th, 2007, the people responsible for preparing a presentation for the president of Lehman exchanged e-mails conveying his expectations: "*Board is not sophisticated around subprime market- Joe* [the president of Lehman] *doesn't want too much detail. He wants to candidly talk about the risks to Lehman but be optimistic and constructive – talk about the opportunities that this market creates and how we are uniquely positioned to take advantage of them". (Page 90)*

The Examiner concludes his assessment of the performance of the Lehman board with the following observations:

"*In hindsight, various Board members stated that it would have been helpful to have more information… On the other hand, the Board did not explicitly direct management to provide it with this information and there is no evidence that the Board asked questions that management did not answer, or answered inaccurately. Moreover, as discussed above,* ***management was not required by any regulatory authority or by Delaware common law to provide such detailed information to Board of Directors.***

Although Lehman's management did not provide the Board with all available information concerning the risks faced by the firm in 2007 and early 2008, that fact is not surprising given the Board's limited role in overseeing the firm's risk management, ***and the extraordinarily detailed information available to management.*** *(Page 185. Emphasis added)*

There we have, black on white, the quintessence of the problem (and the reason why no board member of any financial institution was prosecuted for the 2008 crisis). Under prevailing regulations and legal precedents, board members are blameless; the culprit is in fact the system of corporate governance that has been mandated for publicly traded corporations.

The JP Morgan Chase's Big Whale imbroglio offers another vivid example of the limitations of fiduciary governance in large, complex organizations. A team of traders based in London took very large, speculative positions in synthetic credit derivatives. As the market turned against their position, the team had to value their illiquid portfolio (*the synthetic credit portfolio*-**SCP)** by means of financial models and price testing methodologies. Their valuation had to be vetted by an internal control unit. However, as reported in the SEC administrative proceedings against JP Morgan, the control unit *was unequipped to cope with the increase in the size and complexity of the SCP in early 2012*. (SEC, page 2).

The vetted estimate of the London team was that the portfolio had to recognize a loss of $2 billion as of March 31st 2012. But, after further internal investigation, the actual amount of the loss was revised *to $6 billion;* the quarterly financial statements of March 31st 2012 had to be revised and restated in July 2012.

The SEC and JP Morgan Chase agreed on a settlement whereby JP Morgan ill pay a fine of $920 million and will ***admit wrongdoing***.

One instance of *wrongdoing* was that *JP Morgan Senior Management did not adequately update the Audit Committee concerning the facts learned in its internal reviews*. Thus, again, the board is blameless; management is at fault.

Yet, the sheer complexity of the business of JP Morgan Chase boggles the mind and certainly would overwhelm the typical board of directors. JP Morgan Chase's 10K report for 2012 runs to 414 pages, its quarterly report (10Q) for March 2012 is 182 pages long.

The board of directors, which was called upon to pass judgment on this information and raise appropriate issues, includes several acting or retired executives of large corporations (Boeing, NBC, Exxon, Honeywell, Johnson and Johnson, Spring Industries, KPMG), the president of The American Museum of Natural History and a couple of investment managers. None of them have any experience with the JP Morgan kind of business.

The audit committee is made up of three members: a retired executive of Boeing, the Chairman of Spring Industries (a window fashion business), and the CEO of Clear Creek Properties (a real estate developer). With the best of intention and goodwill, these three people could not challenge the goings-on at JP Morgan.

Recognizing belatedly this unacceptable state of affairs, JP Morgan announced on September 9th 2013 that it was bringing on its board two new members:

the former deputy chief risk officer of JP Morgan and the retiring Chairman and CEO of GE Capital. Whether the former is truly independent is a fair question but, to anticipate on our terminology, she will certainly add credibility to the board.

Boards under attack

Even more telling than these instances of weak governance are the instances where activist hedge funds purport to tell the board what should be done to create value for shareholders. Their challenge to the board is usually supported by analysis and data that the board has not seen before or, if seen, had been persuaded to set aside the actions flowing from this evidence. Suddenly, the strategic options proposed by a hedge fund are received favorably by institutional investors, over the protestations of the board and management.

What has happened recently at Canadian Pacific Railways, a company with stellar scores for "good" fiduciary governance, is a case in point. Its board, made up of experienced people, was humiliated by a hedge fund (Pershing Square Capital, Bill Ackman's fund) which pretended that the company was badly managed. Institutional investors agreed with the hedge fund, voted out a number of board members, supported the change of CEO, and enjoyed a large stock price boost since the coup. That will undoubtedly whet the appetite of other activist funds.

A fundamental dilemma

Perhaps, these instances of boards taken by surprise, inadequately informed or challenged by activist funds should be seen as the unavoidable by-products of «good» fiduciary governance in widely held and complex organizations.

The board's responsibility and accountability are well defined and legally circumscribed. They are to exercise their business judgment on the basis of information provided by management. Management does not bear a legal burden to provide all information to which it has access. The Examiner stated clearly in his assessment of the board's role in the Lehman bankruptcy that «***management was not required by any regulatory authority or by***

Delaware common law to provide such detailed information to Board of Directors».

It may be the best state of affairs achievable under the current form of fiduciary governance. Boards are not to be provided with too much and too detailed information, information that they may be unable to process and which may heighten their level of accountability and legal responsibility.

If so, we should neither be surprised nor critical when boards fail to take action or intervene in a timely manner as long as they are basing their action or inaction on available information. Then, corporate governance of the widely held corporation becomes a fiduciary façade for shareholders, a simulacrum of decision-making authority over management. Board members, through no fault on their part, remain surprise-prone, dimly aware of various goings-on in the company, poorly informed, dependent on a management that they are ill-equipped to challenge.

Is that the best we can do? That is the fundamental dilemma of corporate governance.

Resolution of this dilemma will not come from a further tightening and refining of *fiduciary governance*. The option that must be put forth consists in a new way of governing, a new definition of the role of the board of directors in the widely-held, publicly listed corporation. **Boards must take on a more “activist” role;** but that is a formidable challenge.

Yet, the boards of widely-held firms (and of all organizations without significant and involved shareholders/stakeholders) must cope with this challenge, ***lest governance remains a largely pro-forma exercise, benign in fair weather times, useless in difficult times.***

Indeed, if we cannot cope adequately with this governance challenge, it may signal that forms of business ownership, other than the widely held, stock-market listed, sort, are called for. But given the large economic role that the widely held firms play in many societies, it is unrealistic to expect a swift and broad change over to other forms of ownership.

The current context of corporate governance

As matters stand now, widely held corporations are increasingly influenced by a combination of the looming possibility of being targeted by "activist" investors, the on-going monitoring by proxy advisors with their own agenda, the dominance of impatient investors, and the ever-present threat of short sellers.

Management continues to be subjected to the dictatorship of quarterly/yearly earnings per share (EPS) targets. Boards of directors risk sanctions and negative votes if, for instance, they do not set compensation in a way that links it tightly and exclusively to financial performance and value creation for shareholders.

Boards of directors are not clear about their legal mandate to make decisions in the long term interest of the company, without preferential treatment for any group of stakeholders. Institutional investors, public and private pension funds, endowments and foundations, often agitate more or less effectively against some perceived governance imperfections but are generally quiescent, voicing little support for boards of directors who would be prepared to buck the conventional wisdom and really make decisions in the long-term interest of the corporation and its various stakeholders.

On the contrary, it appears that institutional investors, including public pension funds, often support, secretly or tacitly, the actions of "activist" hedge funds, even supplying them with the capital required to carry on their business.

The Pepsi challenge

The combination of forces which shape the current context of governance creates, at times, very difficult situations for boards of directors and senior management of widely held corporations.

Take PepsiCo as a case in point.

Ms. Indra Nooyi made it clear when she became CEO of PepsiCo in 2006 that she would try to take Pepsi from snack food to health food, from caffeine colas to fruit juices, and from shareholder value to sustainable enterprise. She stated at the time that "she wanted to give Wall Street what it wants but also, the planet what it needs".

"Investors" and analysts tend to believe that this posturing and speechifying by the CEO are all part of a good public relations campaign. The moment of truth comes when the stock falters, earnings disappoint. Does the CEO really believe this stuff?

For Ms. Nooyi, that moment came on July 21st, 2011. At the conference call with financial analysts about its second quarter results, Pepsi had to revise downward its "guidance" for 2011 earnings per share (EPS) growth from 10% to "high single digit".

For these analysts and fund managers of a certain ilk, the writing on the wall could not be clearer: Ms. Nooyi is trying to shift the company slowly towards selling healthier products even if it means lower earnings growth. That may be good for the company in the long run but not for today and tomorrow's stock price.

Over the following months, Ms. Nooyi took all possible measures to convince analysts and "investors" that she was determined to satisfy their expectations of growth and earnings.

But there was blood in the water and soon enough hedge funds started sniffing around. In July 2013, Nelson Peltz, the activist hedge fund manager, announced that his Fund "Trian" beneficially owned in excess of $1.3bn of PepsiCo shares. Peltz then issued a 59-page white paper making the point that "the status quo is unsustainable".

Peltz' white paper states:

- "*PepsiCo has significantly underperformed over a prolonged period of time;*

- *Total Shareholder Return (TSR) at the low end of the peer group since 2006;*
- *Earnings per share (EPS) growth has compounded at approximately half the rate of the consumer staples index since 2006*."

Peltz specifically targets PepsiCo's intention, made at its 2010 investor day, to pursue a new corporate objective: building a $30bn nutrition business (NutritionCo) by 2020.

"We believe the emphasis placed on building out NutritionCo was a distraction from the core portfolio:

- *It led to several high-priced acquisitions, a common risk when an M&A department is tasked with achieving aggressive growth targets in a specific area;*
- *Distractions may have been a contributor to loss of market share in key snacks and beverages categories.*
- *The focus on NutritionCo also led to a perception that management had disavowed its "fun for you" portfolio – the heart of PepsiCo's business."*

Peltz proposes that PepsiCo be split in two stock-traded companies: BeveragesCo and SnacksCo. In his estimation, such a strategic move would produce a 25% return for investors over 2.5 years.

What should the Pepsi board do?

A moment of truth is looming ahead for the board of directors of PepsiCo. The hedge fund will not just go away. It will ask to meet with the board. On what basis can board members reject a proposal that may create substantial shareholder value? To whom are board members accountable? If their fiduciary duty is to act in the long-run interest of the company and they believe that the current strategy is best to achieve that goal, then they should come out with detailed arguments as to why they will not accept Peltz' proposal. Which so called *long-term investors* will publicly support the board's position?

If the board is not sufficiently receptive to Peltz' proposal, he may well initiate a proxy fight to place some of his nominees on the board and to replace current management. Proxy advisory firms will come out with their assessment of the proposal, more likely chiming in favor of Peltz. Fund managers of all stripes may well support, overtly or not, a course of action that purports to translate into substantial returns on their money invested in PepsiCo shares. Some board members risk the humiliation of being voted out by shareholders.

All of this is eerily reminiscent of what happened at Canadian Pacific Rail. In both cases, the "activist" hedge fund comes up with a detailed analysis of the firm's performance and a different course of action. Before the hedge fund had shown up on their doorstep, did the board members ever receive that same information and thoroughly evaluate the course of action proposed by the hedge fund?

If they did not, why not? If they did, then they should have a ready and persuasive response to the hedge fund. Most likely, the board is taken by surprise by the data and analysis put forth by the hedge fund and taken aback by the proposed course of action.

Thus, the actions of so called "activist hedge funds" point squarely at the weakness of current governance practices. Fundamentally, activist hedge funds target companies where they believe the board of directors has been inadequately informed, complacent, readily blessing misguided strategies and rewarding sub-optimal performances by management.

Questioning current governance practices

Dominant governance practices were targeted before. The numerous leveraged buy-outs (LBO) of companies in the 1980s were driven by the belief that the governance of publicly listed companies was weak, "clubby" and incompetent at instilling the kind of management intensity and setting the kind of incentive systems that would produce optimal performance. LBO funds claimed that the right kind of governance could be put in place only if a company was privatized and, as a result, rid of the weak type of governance common in widely held corporations.

The LBO phenomenon eventually stumbled on corrupt and fraudulent practices but left one indelible legacy, for better or worse: the compensation of corporate executives would never be the same; it would henceforth include large stock and stock option grants to "align the financial interest of executives with the value created for shareholders". That was not an unmixed blessing as it prodded management to deliver short-term performances, generated tensions between boards and institutional shareholders, between corporate executives and rank-and-file employees. The resulting, very public, inequality of income and wealth also produced unease and bitterness in the society at large.

Executive compensation tightly linked to share price led, in some notorious cases, to the manipulation of accounting data. It also loaded corporate executives with variable incentives cashable in any change-of-control situation and made them more receptive to takeovers of their company, including their privatization by "private equity funds", the current re-incarnation of LBO funds.

Both private equity funds and activist hedge funds act on the same set of core beliefs. *Much shareholder value is wasted as a result of ineffective governance.*

Their solution differs to the extent that private equity funds buy the whole company and then install the governance, capital structure and strategy they believe likely to produce high returns over a three-to-five year horizon.

Activist hedge funds take a substantial minority position in a company's equity and then urge the board and management to raise their game, to change strategy and/or key executives; they often insist on putting some of their people on the board to bring about the kind of governance that will steer the company towards optimal results.

In both cases, there is an implicit or explicit blame cast on the current governance of the company. Private equity funds nowadays rarely have to get hostile to have their way as management and boards benefit handsomely from the takeover of their company.

Matters get a lot more acrimonious when activist hedge funds show up demanding the replacement of some board members and/or senior executives and challenge the current strategy and management of the company. As hedge funds must persuade other shareholders, usually of the institutional kind, that they are right, boards tend to take up the fight for shareholder support. The outcomes of these bitter proxy fights have often enough been favorable to the activist hedge funds, thus delivering an indictment of targeted companies' governance.

Governance by private equity funds

What if widely held corporations could adopt, or mimic, the kind of governance put in place by private equity funds? Surely, investors would be happy and activist hedge funds would have no case.

However, that will not be easy as there are six critical differences between private equity funds driving the management of a privatized company and the board of directors of a stock-exchange listed, widely-held corporation:

1. The first, and most obvious, difference comes from the time horizon of the private equity fund; privatization of a formerly publicly listed company (or a division of such a company) is a transient state; the privatized unit will be brought back to the public markets or sold to another company within a three-to-five year horizon (sometimes a bit longer depending on financial market conditions). A publicly listed company has an indefinite life; it cannot gear all its actions and strategies to a single goal: maximize the value of the equity in the short term. Private equity funds also use various subterfuges to quickly extract from the privatized unit all the cash they have invested in it. Publicly listed companies cannot resort to these financial maneuvers.
2. Compensation of management, post privatization, is linked in large part to the actual cash value realized from selling the privatized company or from bringing it back to the stock market. Post-privatization managers are often required to commit substantial sums of their own (or borrowed) money to acquire shares of the privatized company and are

thus rewarded for tangible economic value they have created and the risks they have taken. By contrast, the compensation of corporate executives, relying on benchmarking the compensation paid to executives of a group of "comparable" companies, is largely made up of annual grants of stock options and restricted shares. The cash rewards of such a system are highly contingent on luck, financial astuteness and the stock market's chronic variations on which management has little control.

3. Board members of the privatized company, often made up of general partners of the fund, are compensated at a level and in a manner hardly conceivable for board members of a publicly listed company.
4. Board members of the newly privatized company must not be "independent" and rarely are; a majority of board members of publicly listed companies must be "independent".
5. The boards of listed corporations must discharge fully all their fiduciary and legal responsibilities; that component of governance, an ever expanding one, grabs a good portion of the time available to board members; privatized companies do not have to deal with these hassles and can concentrate on strategy, cash flow management, etc.
6. The board of a privatized company will call directly on outside consulting firms to assess the company, its competitors and so forth, and the external consultants will report directly to the board. Now imagine that the board of a publicly listed company were to inform management that it intends to hire some firm to audit the company's strategy and benchmark its performance. That would not fly well and would certainly create tensions between the board and management. Management would claim that the board is straying from its governance role, that this type of initiative is tantamount to a vote of "no confidence" in management; it would contend that the company regularly gets this sort of studies and reports to the board on their results, etc. So it has come to pass that an outside "activist" hedge fund could challenge the board of CP with data and analysis that were persuasive to a majority of shareholders.

Clearly the boards of privatized companies are *activist boards*. Activist hedge funds claim that the boards of the companies they target have not been "activist" enough. Can corporate governance be changed to give boards more of an activist role and capability? That is the challenging question we are addressing in this paper.

What is to be done?

In a piece we published in 2003[1] we outlined how we could move from the fiduciary sort of governance to ***value-creating governance.*** In some ways, we were addressing some of the six differences listed above.

1. **Legitimate and credible board members**

First, instead of stressing "independence" of board members as the *Philosopher's stone* of "good" governance, we should focus on building ***legitimate and credible boards***. Framed as one source of legitimacy, the concept of independence gains a restricted but critical role in the functioning of a board. It does provide a relative assurance that the director's judgment will not be influenced, nor appear to be influenced, by his or her interests rather than by the interests of company stakeholders.

But a board acquires ***legitimacy*** through the process of election/nomination of board members and/or from the sizeable financial investment in the company's shares by board members. Indeed, *only through its legitimacy does a board acquire moral authority over the management of an organization*

Several measures have been proposed to enhance the legitimacy of boards of directors, such as cumulative voting, nomination of candidates for board seat by large shareholders, individual and majority voting for candidates to the board, stakeholder representation on boards, etc. All measures aimed at strengthening the legitimacy of boards deserve a vigorous support from those committed to improving the quality of governance in our private and public organizations.

Should board members make a substantial financial commitment to the business corporation they will govern? That suggestion is controversial. Many

[1] Allaire, Y. and M. Firsirotu, *Changing the nature of governance to create value*, C. D. Howe Institute, #189, November 2003.

claim that this feature would make the board members more focused on their own interests rather than the long-term interests of the company. Yet, the empirical studies are clear; board members with substantial stakes in a company act more quickly to remedy bad performances. *No board has more legitimacy to impose its will on management of a business corporation than a board with a lot of money at stakes.*

Credibility is the joint product of competence, integrity, and trustworthiness. A director's credibility results from his/her expertise about, and experience with, the ***specific*** **issues and challenges of the company. T**he unfortunate fact that many board members lack credibility explains the weak performance and the little added value of governance in too many organizations.

The acid test of board members' credibility resides in the answers to the following questions: Do members of the management team believe that discussions with the board are fruitful and challenging, bring new perspectives and viewpoints, and add value to the decision process? Does management believe the board members really understand the business, its key metrics, and its success factors? Does management trust the board and respect its competence in raising all the pertinent issues? Do board members have the time and the intellectual vigor to acquire and maintain an in-depth understanding of the company?

It may well happen that a credible member may not be an independent member, *stricto sensu*. By virtue of his/her work experience in the industry, a candidate board member may fail the exacting tests of "independence" but bring much credibility to the board. Corporations must be prepared to trade off independence for credibility for a number of members of the board, if that became necessary to assemble a credible board.

While it is legitimacy that gives a board the moral authority to impose its will on management, it is through its credibility that a board becomes effective and adds value to the company.

Clearly, for some forms of business ownership, the legitimacy and credibility of their governance is easier to achieve, though difficult issues do arise from time to time.

For instance, when a significant or controlling shareholder plays a key role in the governance of the company, legitimacy and credibility are more easily achieved. People with large stakes in the company have great legitimacy to assert their authority over management; they also enjoy that elusive quality of credibility. Frequently, they have actually built the company; they know intimately every building-block; they are motivated by their monetary commitments and their legacy to invest massively their time and energy in the governance of the company.

However, in the typical widely-held publicly traded company of high complexity, the board, though of some legitimacy, may lack credibility because most of their members do not have an intimate knowledge of the organization or a mastery of the particular economics of the business.

Given board members with the requisite experience and intellectual wherewithal, enhancing their credibility requires a large investment of their time to master the details of the company's strategic drivers, its competitive challenges, and maintain the currency of that knowledge. *At this time, board members will not become or remain credible if they do not master the immense search capability of the Internet* to ferret out the information pertinent to the company they are called to govern.

2. Compensating board members and management

The subject is touchy and complex. Logically, requiring board members to invest a lot more time in the governance of the company (and restricting sharply the number of their board memberships) must lead to changes in the level of board member compensation. But issues raised by such a proposal must be addressed:

- Given that board members may be of variable ability and expertise, should not their contribution be rewarded differently?

- Is there not a risk of boosting the compensation of board members without much else changing in their behavior and effectiveness?
- As board members must act in the long-term interest of the corporation and its various stakeholders, what part of their compensation, if any, should be linked to stock price?
- If the compensation of board members were to be increased substantially, can we be assured that the evaluation of board members will be rigorous so that no member of the board gets to be richly compensated for little value added?

These questions must be answered but they are not insuperable obstacles to the goal of bringing about more credible and value-creating boards. But, *in fine*, board members must be paid more if they are to invest more time and effort in the governance of the corporation.

However, one of the key challenges of a credible board is the setting of executive compensation. Boards of directors must remain fully accountable and responsible for the setting of executive compensation. As a result of a confluence of factors, such as the role of compensation consultants, the second-guessing by proxy advisors, the Damocles sword of the say-on-pay vote, boards have lost control over the process of setting executive compensation.

Boards of directors must assert anew their authority over compensation. They must be credible enough, have enough courage, to set compensation on the basis of *qualitative* as well as quantitative factors they deem of great importance to the well-being of the company in the long run.

The members of the compensation committee of the board must have the requisite competence (including in financial matters) to tailor a compensation program to the very specific circumstances of their company; compensation programs and actual pay-outs must be tightly coordinated with the audit and risk management committees.

Boards of directors must abandon the false notion that there is a surrogate market price for executive talent, a price set by what a group of *comparable* companies pay their own executives. That is the weakest link of the whole system put in place by compensation consultants. But that was the best answer they could come up with when asked to price executive talent.

Executive compensation should be linked to *quantitative and qualitative* indicators which drive the economic performance of the company, which **increase *the long-term value of the company.***

Boards of directors must understand fully the business model of the company, the sources of its value-creation. Every company is somewhat different in this respect and cookie-cutter programs will not do the job; quantitative indicators should not be stock-price related but of the sort that do measure the long-term health of the company, such as Return on Invested Capital (ROIC) and Economic Value Added (EVA); management should also be assessed and rewarded for its performance on the more qualitative and subtle aspects of the company's ethics, the sense of belonging and fairness felt by most members of the organization.

The competence of management at factoring in its operations the concerns of society at large and the expectations of key constituencies should be reflected in the compensation system of corporate leaders. The success and survival of the corporation hinges on first rate performance on this score.

However, some of the contextual factors of corporate governance described earlier must be changed, otherwise executive compensation will continue to be dysfunctional in terms of the behavior it drives and the values it fosters.

3. The board's role in strategy making and strategy implementation

This crucial role of the board for widely-held public corporations comes on top of the multiple rituals and nitty-gritty, time consuming, aspects of fiduciary governance, for which boards are legally responsible. Thus, value-creating governance calls for more board time, more board meetings, and better compensation for board members.

How a board contributes to strategy-making and strategy implementation becomes a significant test of its "activism".

In its very essence, strategy is all about *finding, creating, maintaining and protecting market imperfections which are favorable to a particular business firm.* (Allaire and Firsirotu, 2004, 2006)

Tapping into these market imperfections may call for large investments and negative returns for a period of time. But these investments must be expected to produce, in present value terms, a return on invested capital (ROIC) greater than the cost of the capital.

Eventually, as a going concern, the proof, or demonstration, that a firm's strategy and business model creates value rests with its ability to deliver on a consistent basis a return on invested capital (ROIC) greater than its weighted average cost of capital (WACC). So ROIC/WACC > 1.0 (or ROIC – WACC > 0) over a period of time provides *the clearest indication that the business firm is benefiting from some market imperfection!*

Market imperfections take on myriad forms: strong brand loyalty, patented innovations, a network of prime store locations, a culture of loyalty among the skilled employees of the firm, favorable regulations, market concentration through acquisitions, and so on with a list limited only by the imagination of entrepreneurs and strategists.

However sustaining value creation is tough. Competitive forces – including innovation- tend to drive returns toward the cost of capital. That's what the board needs to understand and the basis on which it should assess management's actions and skills.

The board must understand in sufficient depth the "business model" of the company, the market imperfections it is tapping, in order to assess proposed investments and strategic moves. Not an easy task but a task that only a credible board can hope to accomplish.

4. Designing the board's information system

Assuming, and it is a key assumption, that the board is made up largely of credible members, what kind of information should it receive and collect to shrink somewhat the gap between management's overwhelming information advantage over the board. Each board should decide on the kind of information needed to govern their very specific organization and must ensure access to independent, unfiltered sources of information.

What could an information designed by and for board members look like?

The board should ensure that it is getting reliable and valid information concerning the firm's performance on several dimensions:

1) *Competitive and client performance*:

How do we stack up against competitors? What do clients think of our products and services, compared to those of competitors?

2) *Economic and financial performance*:

What is the economic performance of the company compared to competitors? What do we deliver in terms of financial performance? Does the company create real economic value?

3) *Organizational performance:*

What is the level of job satisfaction in the company? How is senior management viewed by rank-and-file employees? What values are communicated and practiced in the company?

4) *Social performance:*

How is the company perceived as a corporate citizen? How do we rank in the public's estimation of our contribution to society? What is our record on social responsibility in the areas of environment, fairness of treatment, and so on.

The board should hire independent providers of information who will report to the board at given intervals on the performance of the company on relevant indicators of these four areas of performance. The ability of board members to properly assess and draw conclusions from this assemblage of information hinges on a fairly high level of quantitative, financial literacy.

Management and the board will be involved in the design of the instruments and the development of the indicators. But the outside contractor works for the board exclusively. At first, management may have some difficulty in accepting this principle; however the inescapable responsibility of the board as the ultimate decision-maker gives much support and credence to this way of governing.

Furthermore, board members must become conversant with the information potential of the Internet. They should set up, or the board should arrange for a consultant to set up, on their individual computer (or tablet) warnings to signal any information relevant to the company which has appeared somewhere.

Their individual system should be linked to credit rating agencies, proxy advisors, relevant financial analysts, important media, key competitors so that if any information pertinent to their company appears, board members are immediately informed. Board members should make a practice of navigating the Web to consult the investor presentations of publicly listed competitors, links to institutional investors with a stake in the company, chat rooms about the company and so on.

These characteristics of governance shape what we called "***The Four Pillars of Value-creating Governance"***, illustrated in our Figure 1.

Conclusions

In the Anglo-American model of the widely-held, publicly traded corporation, governance is largely a mirage. For those looking from afar, the board of directors looks like a decision-making and controlling body, the ultimate authority over the company and its management. From up close, the mirage dissipates into a stark reality where impeccably independent directors, no matter how impressive their biographies, are dependent on a management with an insuperable advantage in information, in time invested, and in specific expertise.

The challenge for a board to take on a more active role, a value-creating role, is a formidable one. To transform governance along the lines described in this paper will call upon major changes in the ways board members are selected, rewarded and trained.

Board members should have a deep knowledge of the sector of activities in which the organization operates, or the educational, intellectual and experience wherewithal to acquire rapidly such knowledge.

Compensation of board members must be adjusted to the demands of an activist role.

The education programs for future board members should be overhauled to include more substantive training in strategy, finance, social and organizational subject matters.

Insertion programs for new members should be replaced by continuing, intense training on key aspects of the organization's performance.

Figure 1


Four Pillars of Value-Creating Governance
High Performance Governance Systems
Corporate Architecture and Leadership
Strategic Management and Implementation
Information System and Performance Monitoring
Incentives and Reward Systems
• Credibility and legitimacy of board members
• Core corporate values
• Structure and design
• Clear understanding of "business model", of the market imperfections favorable to the business;
• Value-creating Investments to support business model
• Reliability, timeliness and integrity of information
• Quality of strategic information
• Focuses operating managers on market, economic, organizational and social performances
• Rewards genuine economic value creation
• Pushes for profitable growth
• Balances short and medium-term calculus
• Aligns operating management's interests with that of stakeholders
Essential but not sufficient condition
Defines a strategy consistent with business model
• Reduces information asymmetry between board and management
Rewards true performance as measure by qualitative as well as quantitative indicators
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