Proposed: A Governance "Monitor"

by Mark Latham

Our corporate governance system is based on the concept that shareholders elect directors, who in turn hire management. Yet many find this system tipped in favor of management. The CEO and inside directors can influence director nominations, which may be contrary to the interests of shareholders. Mark Latham proposes a "monitoring intermediary"—an independent firm that recruits the slate of directors, and monitors results.

If you want something done right, do it yourself. If you hire people instead, they may not do it the way you want. This is the agency problem in economics. In the case of a large company owned by many shareholders, managers are hired to make the daily executive decisions on the owners' behalf. However, they often have incentives to make decisions that are not in the shareholders' best interests.

A firm's board of directors is supposed to oversee management and ensure that shareholder interests are being served. Still, the directors are merely human economic agents following incentives that may lead them to favor management over the shareholders, especially because of the director nomination and election process. Shareholders elect the directors, but there is usually only one slate nominated, by the board's nominating committee. This enables a management-dominated clique to maintain control of the board indefinitely.

Shareholders can sue management and the board for breach of fiduciary duties. In practice, though, it is so difficult a court to distinguish self-serving from incompetence and bad luck that lawsuits can guard against only the most flagrant abuses of management power.

Shareholder activism has become the dominant disciplining mechanism in the last ten years. Large public pension funds, especially the California Public Employees' Retirement System (CalPERS), have put pressure on boards and management of underperforming firms to shape up or lose shareholder votes. Investors are limited by lack of knowledge of how the firm should be run—one of the reasons for hiring management in the first place. The more knowledge owners can acquire, the better they can oversee management, but the time and effort involved are monitoring costs that can only be recovered by a rise in the value of their shareholdings.

Why not an independent entity to nominate director candidates? This "monitoring entity" would objectively review the performance of both the company and its directors.

A major limitation of the existing system of selecting outside directors is that it can be controlled by management. Even though these directors may have no other formal ties to the firm, candidates can still be screened to ensure friendliness to the CEO, and those who rock the boat can be omitted from nomination next time. For such reasons, several authors have focused on the nomination mechanism as the key point for improving corporate governance.

Why not let shareholders choose an independent entity for nominating director candidates? This would make directors responsive to owners rather than to management, while avoiding the free-rider problem that limits other solutions. Furthermore, adopting this idea could be the thin end of a wedge, which would fundamentally alter the role of the board.

The nominating entity would need to monitor director performance in order to decide whether to nominate a given candidate again, for the same board or the board of another firm. Furthermore, it could perform additional monitoring functions if requested by a majority of shareholders. Call it a "monitoring intermediary."

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An annual shareholder ballot would choose the nominating entity for the following year's director elections. It may be best to offset these by six months, for example voting in November to choose who will nominate director candidates the following May.

Who nominates the nominators? To forestall management and the board from restricting owners' choices, any shareholder could name an entity to go on the ballot. Frivolous entries seeking free advertising can be prevented by an up-front fee of, say, three percent of the amount to be paid under the resulting executive search contract. The number of candidate intermediaries on the ballot would ideally be between two and ten.

A shareholder vote to choose one monitoring firm from ten competitors raises the problem of vote-splitting. For example, what if there are nine candidate firms known to be good shareholder advocates, but one that is overly friendly to this corporation's management? If a management clique owns 25 percent of the shares, management's monitoring firm may win.

The intermediary allows shareholders great monitoring power with minimal information costs. They would survive by building a good reputation, much like accounting firms.

Preferential voting can solve this problem. Rather than voting for just one candidate firm, shareholders can rank the firms, indicating their first, second, third choices and so on, and a computer finds the most preferred candidate. In the example with nine good candidates versus a single bad one, the 75 percent of the shares outside management control would tend to rank the management candidate last, so that one of the nine will win.

Having an outside entity nominate directors need not preclude nominations via the existing mechanisms of the board's nominating committee, and the occasional opposing slate from a dissident shareholder group. When shareholders vote to choose among these nominees, it is important that the ballots indicate who nominated which ones. Shareholders are likely to favor those nominated by the monitoring firm they have chosen.

Monitoring by intermediary firms enables shareholders to make powerful monitoring decisions with minimal information costs, thus avoiding the free rider problem. Choosing good candidates for the board of directors is generally too complex for meaningful input from many shareholders, one reason why nominating is done by a board committee, and why there are rarely competing slates.

However, ten or twenty firms providing monitoring services nationwide can build reputations sufficient to form intelligent choices among them, with only a casual reading of a newspaper's business section. Think of accounting firms as having similar investments in reputation. The typical shareholder would be hard pressed to name a good director candidate, but most can name a good accounting firm.

Each monitoring firm would strive to build a reputation for sound business judgment and independence from the managers of the corporations it monitors. Compared to an individual director, such a firm would provide services to many more client companies over many more years, permitting a far more accurate assessment of its capability.

Introducing monitoring intermediaries into a corporation is such a fundamental change that it is difficult to anticipate the eventual results. Learning from experience with a step-by-step approach should enable shareholders to find the best use of this tool.

As a minimal first step, it may be wise to have the intermediary nominate just one candidate for board election. This would pose no immediate control threat, and may thus meet less opposition. Although it raises the risk of conflict among board members, that is more likely to be constructive than destructive. It is not in shareholders' interests to nominate a director whose influence would hamper the profitable operation of the firm. If shareholders trust the monitoring firm's reputation, they would vote for it to nominate a full slate of directors next year.

If the independent nomination process is found to benefit shareholders, the monitoring firm's role could be expanded. Suppose the monitor nominates a full slate of board candidates, who routinely get elected. Then shareholders might decide that it would be more effective to eliminate board elections altogether, voting only on their annual choice of a monitoring firm, which could then populate the board as it sees fit. Directors would effectively become employees of the monitor, which thus becomes less an executive search firm than a management consulting firm. The monitoring firm would be paid a headhunting fee plus the directors' fees, in return for oversight services.

The primary goal for improved monitoring of management is enhanced shareholder returns. This can be achieved by a more judicious deployment of capital. CEOs have been known to enter, maintain, or expand favorite businesses even when it is not economic to do so. A strong independent board can prevent this. With effective shareholder representation at the bargaining table, top executive pay will be closer to the fair market value of each manager's contribution. Oversight of the process of training and promoting middle managers can prevent a clique from monopolizing the knowledge of how best to run the firm.

Corporations tend toward "short-termism" when investors distrust management and rely only on immediate results. The governance monitor could reduce this short-term investor anxiety by promoting true value.

Diffusing the intense power of the CEO should make the whole firm less hierarchical. It will no longer be worthwhile for the CEO to spend much effort maintaining a tight grip on power. Instead, a good CEO will benefit from no longer being surrounded by yes-men.

American companies are often accused of "short-termism"—favoring current profits at the expense of the long-run value of the firm. This can lead to neglect of such things as investment in research and development, plant modernization, employee training, product quality, and risk management.

Such a tendency is often blamed on management being pressured to focus on the firm's stock price, which responds strongly to current earnings and dividends. In theory the current stock price should reflect expected future earnings from investment in R&D, reputation etc., so that emphasizing stock price should not induce short-termism. However, if investors lack information about these long-term investments, and do not trust management to invest optimally, they will favor the benefits they can verify—current earnings and dividends.

A monitoring intermediary answerable directly to shareholders may be able to reduce short-termism. Compared to a CEO or director, a monitor provides services to many more companies for many more years. It has to build its reputation for promoting the true value of the client company.

We can see how a lack of information limits the effectiveness of monitoring, by looking at how CalPERS, the leading activist investor, chooses the targets of its pressure. They focus on underperforming firms, those whose market value has lagged in recent years. Yet the firms most likely to waste resources are those that have the most to waste — companies that have been generating substantial cash flow. Better to forestall waste before it leads to loss of market value, rather than just locking the door after the burglary.

However, effective monitoring when there is no obvious problem requires an investment in more inside knowledge of the firm. Partly because shareholders lack such knowledge, the existing system tends to shift some power from managers to shareholders only when market values have already suffered and the damage has become apparent. Even then the losses may be bad luck, not bad management, but the free-rider problem makes it uneconomic for shareholders to learn enough to make that distinction. So a monitor funded by all shareholders promises to be an effective remedy.

The monitoring system proposed here harnesses competition and the profit motive for the benefit of many. Share ownership is broadly distributed, especially through pension funds. The corporation's treatment of its other stakeholders can also be expected to improve. These include employees, customers, and the general public. If an improved monitoring system can earn shareholders' trust, they may be more willing to encourage management to pursue public interest goals in addition to making money. Removing the incentive for empire-building would, over time, decrease monopoly power, enhancing competition to the benefit of consumers.

With a monitor, small shareholders will no longer need big investors to go to bat for them. Big investor activism is often a mixed blessing.

The advent of monitoring intermediaries would diminish the importance of large shareholders. To the small shareholder, large shareholders are a mixed blessing. They may undertake costly monitoring of management, to the benefit of all owners. However, they may extract value from the firm to the detriment of other owners, such as by receiving greenmail, "white knight" deals, or inside information.

If shareholders vote to hire a monitor, they will no longer need large shareholders to go to bat for them. A shareholder or group holding close to half the shares could control the choice of monitoring firm, however, and exploit that power at the expense of minority owners. Thus agency costs may be reduced by imposing restrictions on accumulating large blocks of shares, since the monitoring benefits are no longer needed. So as not to lose the potential efficiency gains from a complete overhaul, sale of the entire firm to a single acquirer could still take place if approved by majority shareholder vote.

Developing a system of monitoring intermediaries must be expected to do some harm, but far less harm than good. First, mishaps are inevitable when exploring new territory. If shareholders try a new oversight structure that turns out badly, they can vote to amend or rescind it. Second, benefits should be pursued until they are outweighed by costs at the margin. The monitoring firm's power and budget should be expanded until there is evidence of some waste or other negative effects.

Firms are justifiably concerned about leakage of proprietary information to competitors, and if an outside monitor is peering into several firms, this risk is exacerbated. The principal defense against this is the need for the monitoring firm to maintain its reputation. If there is evidence of substantial leakage, it will lose shareholder votes. This may well be a better protection than under the existing system of directors, who have less of a long-term reputation to protect, and are less answerable to owners.

CEOs and their loyal directors will oppose hiring monitoring intermediaries, but they cannot prevent it if a majority of the firm's owners are in favor. Public discussion and debate will shape shareholder opinion on the merits of this idea and the specific form in which it should be first attempted. Then a shareholder proposal to retain such an intermediary should be put forward at a firm where it has the best chance of winning a majority of votes—whose owners believe they would benefit from a truly independent board. This could be accelerated by like-minded investors buying shares in such companies.

How can shareholders hire a monitoring intermediary firm when no such thing exists? The market would create them once there is demand. By the time a majority of a corporation's owners decide they want such services, someone will offer them. Assuming the first proposals are for independent nomination of director candidates, the first to step up are likely to be executive search firms.

The corporate monitoring firm is a market-driven mechanism enabling shareholders to exercise their property rights by influencing how their companies are managed. It avoids the free-rider problem, and its cost is more than offset by resultant savings and efficiency gains. It promises to raise the productivity of capital, reduce the short-termism of American management, and make corporate power structures less hierarchical.

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