Below is the first idea I [Mark Latham] had on how to improve corporate governance using a shareholder - elected monitoring organization paid with corporate funds. I wrote it in a letter while I was an assistant professor at the University of California, Berkeley. The addressee and some irrelevant paragraphs are omitted here.

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The morning after our dinner I was lying in bed thinking about corporate management-vs.-shareholders agency problems, and I had an interesting thought which I'd like to bounce off you. So get ready! The typical management consulting firm (like SPA) is hired by top management (like the CEO). I think it would be very beneficial (but maybe politically impossible) to have a consulting firm hired *directly by the shareholders*. They would be an independent monitor of management, with no executive power except to spend a limited budget authorized by the shareholders for their consulting time and expenses. They would give advice to management, like a normal consulting firm, but a key distinctive service they would provide is periodic (annual?) reports to shareholders. The reports would rate the management's quality from the point of view of the shareholders' economic interests, and give independent "minority opinions" on key decisions and policies of management that the consultants disagree with. This service could be called a "management audit".

Now maybe such arrangements already exist, or maybe they would be unworkable, but I'd like to hear what you think. The Board of Directors is supposed to be the power/control conduit between shareholders and managers, but it seems they often don't do the job effectively. Perhaps they aren't paid enough to take a more active role, and can't be paid enough because of conflict of interest between them and other shareholders. I hear they are often "in management's pocket" and believe what they are told.

So why would "management auditors" be any better? A crucial feature would have to be the <u>reputation</u> of the management auditing firm. They would frequently be in the position of disagreeing with management. If they only had <u>one</u> client firm, then management could just argue that the auditors are wrong, stupid, knee-jerk antagonists. But if they have many clients (the way consulting firms do) and they give much better ratings to some firms' management teams than to others, then they can't be accused of being such a "stopped clock". (Unlike most consulting firms, management auditors' clientele and reports to shareholders would necessarily be public.)

A tricky issue is that of how much of management's information the auditors should be authorized to have access to. I favor a lot of access, and depend on the auditors' reputation to keep them from revealing things that may help the client firm's competitors.

Other miscellaneous thoughts on this: A company with a management auditor would have less need to hire other consultants (like SPA), so the money spent on auditors is not just extra money spent, but would replace some spending on outside consultants and/or internal management too. Takeovers are prime examples of the conflict of interest between (target firm) managers and shareholders, so an auditor would play an important role in giving an opinion on whether shareholders should accept an offer or whether defense measures should be taken. An auditor might advise against a client firm's attempt to take over another firm. A management auditor would be the natural audience for employee "whistle-blowers" who could report bad management anonymously with less fear of retribution. The management team would have the benefit of an independent opinion source that is not a "yes-man" (whether they like it or not!). Even more than is the case with normal consultants, management auditors need not have great expertise in the particular business of the client firm, although it would help. The mere fact that management is subject to audit will go a long way toward keeping the managers acting in the shareholders' interests. The ideal relationship between managers and auditors would be one of consultation and cooperation -- both providing independent views of how best to run the firm. But a fair amount of conflict would be natural and (I think) mostly healthy.

If this service doesn't yet exist, who should offer it? Existing consulting firms would seem to be in the best position, since the service they have experience in offering is so similar. But I see a big problem for them: they might alienate "the hand that feeds them" -- top management at their conventional consulting clients -- thus losing a lot of business. So maybe a new firm should be started with people experienced in conventional consulting.

I guess the main obstacle to this idea is the political one: how can a would-be management auditor get itself inserted into a firm's power structure? I don't know enough about the mechanics of voting and annual general meetings. Do you know a good corporate lawyer?

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Best wishes,

[Mark]