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To Our Clients

Corporate Governance

The article in today's Wall Street Journal, "Calpers Goes Over CEOs' Heads In Its Quest for Higher Returns", demonstrates the validity of my prior advice to preempt the activist institutional investors and establish the company's own program to provide access to its outside directors.

In our dissent to the Report of the Subcouncil on Corporate Governance and the Financial Markets of the Competitiveness Policy council, Jay Lorsch and I addressed the issue in this way:

> We recommend that the board of directors (including its management members) meet annually or biannually in an informal setting with five to ten of the larger investors in the company. The purposes of the meeting are to facilitate communication between the institutions and the outside directors and to avoid misunderstandings, particularly to dispel the views of some institutions that outside directors are not knowledgeable about the business of the company and are overly tolerant of underperformance.
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> The informal format of the meeting allows the institutions to talk to the directors both as a group and on a one-on-one basis. While senior management will be present, arrangements should be made to permit conversations between the institutions and outside directors without management, if the institutions so desire. In many cases it would be desirable to start the meeting with a presentation by senior management and then follow it with an opportunity for dialogue.
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> In view of the limited number of senior personnel available to institutional investors for the purpose of this type of meeting and the advantages of diversity, invitations should be rotated among the larger holders so that the same institutions are not invited regularly. Companies that are performing well may find that personnel constraints result in the institutions not accepting the invitations or asking

that the meetings be scheduled on a four or five year basis rather than a one or two year basis.

Several arguments for not having these meetings have been advanced: (1) they will result in the disclosure of material nonpublic information, (2) they are an undue imposition on the time of the outside directors, (3) they invite attempts at micromanagement by institutions, (4) a few activist institutions will be "anointed" as having a special relationship with the company and (5) they discriminate against the small individual investor. While there is some substance to each of these arguments, they do not individually or in the aggregate outweigh the advantages of these meetings.

The inside information issue is readily dealt with. The meeting can be timed to take place shortly after either quarterly or annual financials are issued. The "Management Discussion and Analysis" section of the financials should cover whatever might be of interest in the type of discussions that normally would take place. In large measure the procedures and safeguards that have been evolved for dealing with analyst meetings can be adapted for this meeting. Further, all participants in the meeting are aware of the inside information problem and are accustomed to dealing with it. Since only longterm institutional holders would have an interest in attending the meeting (short-term holders would have sold in the market as soon as underperformance was perceived), the attending institutions would, in addition to not seeking inside information, be willing to not act upon it if through inadvertence they received it.

The meeting and preparation for it will require that the directors devote additional time. A day for the meeting and a day for preparation are reasonable estimates. This is a small and worthwhile investment of time if it avoids the much greater amount of time consumed when a company falls out of favor with institutions and becomes the target of a proxy resolution campaign.

Almost all the institutions disclaim any desire to micromanage and there is no indication that there is any change in prospect. The institutions do not have the staff or the experience to evaluate management decisions or corporate strategies. Nor is it in their self interest to incur the significant costs to create such capability.

The concern with developing a special relationship with certain institutions is readily met by rotating the institutions invited to the meeting. Different institutions can be selected for each meeting. There is no need to invite back the same institutions each year. While it is easy to avoid the "anointing" problem, consideration should be given to developing special relationships with long-term institutional holders who will take larger stakes in the company and encourage the management to pursue long-term strategies. This is a key recommendation of Michael Porter in "Capital Choices: Changing the Way America Invests in Industry" and a number of other thoughtful students of corporate governance.

This type of meeting does not discriminate against the small individual investor. The format of the meeting is not appropriate for small individual shareholders and there is no reason to feel that all shareholders should have the same programs available to them. Most companies have special investor relations programs for small shareholders and small shareholders benefit from the meeting with institutional investors along with all shareholders, large and small.

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