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Boardroom Intelligence

6 From NACD
Kenneth Daly: Why Be a Director?

10 Need to Know
Shareholders rising, PE bottom feeders, SEC's new take on risk, more

18 **Verbatim**
Ralph Whitworth is Raising the Stakes

20 Henry Kaufman: No More Dr. Doom

NACD Report
50 Achieving Greater Transparency

55 SPECIAL REPORT
Director Education

Viewpoint
61 Herbert S. Winokur: Common sense for new directors

64 In Practice
Jay R. Galbraith on the decline of COOs

74 Readings
Posner, Fox, Krugman, Triana place blame

76 Postings
New directors at Cisco, Sears, Shutterfly, more

80 Boardroom Journal
Jeff Cunningham on the magic elixir at Goldman Sachs and P&G's peer group

The *New* New Deal

President Barack Obama and his team top our third-annual list of the *Directorship* 100, the most influential people in the boardroom and corporate governance community. 22

Verbatim

Raising the Stakes

An investor and director on the future of risk oversight and the new role of boards.

The surprising fact about Ralph Whitworth, co-founder of Relational Investors, is that he loves great CEOs. The reason some may find this surprising is that he is best known for taking huge stakes in underperforming companies and pushing for change, which sometimes comes in the form of a new CEO. You could call this Relational's business model. Whitworth's investing hallmark is that when he buys into a company or joins its board, he becomes a student of that company and its business, and treats board service as a subject to be reviewed intensely. He believes that to know what is really going on "takes a lot more research than most outside directors are willing or able to do." Finally, his greatest impact is achieved when he can affect the dynamics of the boardroom—finding great managers or fixing existing ones, driving outstanding strategic planning, and focusing on shareholders' returns.

Ralph Whitworth

What's changed for board directors in light of the financial crisis?

I've learned as much in the last two years as I have in the last 20. We should be required to write Counterparty and Risk on our agendas in bold, capital letters. Previously, the board discussed risk on an annual basis. And it was something managed by the compliance department. I sat on a board as all this began to unfold. When we stepped up our discussions with the risk management officer, we were surprised by the number of areas we would ask about and he would say, "That's not under my purview."

Is there a potential boards could get too risk averse?

We may have the equivalent of Depression babies in the boardroom. If we run our companies like the last two years were the norm, then definitely there's going to be too much focus on risk. But certainly there wasn't enough in the past.

How does a board get its arms around risk?

Old fashioned sensitivity analysis. The analysis that was usually presented to the board for a given transaction was one-dimensional or the sensitivities were tested in too narrow of a band and failed to take into account enough of the exogenous events in the real world. Part of this, of course, can be attributed to management selling their initiatives and part of it is just a process to which we fell victim. Once you properly illuminate the risks, then you can intelligently think about "go or no go," mitigation, and offsetting actions.

Concentration intensifies risk. Should we all become more diversified?

Diversification can be a bit of a mirage. In the mortgage market, if you look at some of the hybrid instruments that we now call toxic—they took groups of BBB-rated credits, put them into structures with diversity of regions and industries and called them AAAs, but they were still just a bunch of BBBs. And when things hit the fan, unsurprisingly, they behaved like BBBs and collapsed. If you go back to some of the old-timers who did work in the banking industry back in the 1940s and 1950s, using basic risk-management concepts, they found effective ways of managing risk within otherwise homogenous product lines. Plainly, they were better at underwriting. They had no choice, because they couldn't count on passing the risk off through some exotic securitization.

If you are going to be obsessive about market share does that lead to additional risk?

Obsessive pursuit of market share often relies on lower prices and increased subsidies. This is particularly true in mature or commoditized industries. We see this happening today in the wireless telecom sector and we saw it with the mortgage bull market. In these industries, the only way you materially increase mar-

ket share is by taking more risk or accepting lower returns and it usually requires both. You hear "We're better at servicing or we're better at sourcing," but at the end of the day, it's a commodity. So anyone growing significantly faster than the pack is, by definition, taking more risk.

There's a fixation on compensation these days. What's your take?

You know this is one area that has been a colossal failure on the part of boards. Can we all agree that you simply should not leave the determination of compensation to a process dominated by those being compensated? Reform has to start with a vigorous attitude by the compensation committee. Human nature is a constant; what changed over the years were the perverse incentives compensation committees allowed to creep into our system. We hear a lot of talk about short-termism these days, but it starts with executive compensation that is heavily weighted toward annual cash bonuses and equity incentives that essentially get reset once a year. It's no wonder our financial sector became so amazingly creative and skillful at trading short-term cash for long-term tail risk while dressing it all up as growth. This is exactly how their incentives were set. For decades, Alfred Sloan enforced a system at General Motors where management received a nice base salary and then ten percent of the profits over a return of six percent. By the mid-1970s, the concept of requiring a return on investment before paying incentive compensation disappeared. It may sound simplistic, but both the financial crash and the demise of our auto industry were really all about perverse incentives.

What types of investment opportunities do you look for, companies you think have poor governance?

We invest in companies that we think are underperforming against their potential in terms of their stock price value. That usually means there is a problem in their operations or capital allocation or some fundamental area of performance. Poor governance, more specifically poor board dynamics, invariably accompanies that underperformance. We leave it to the academics to decide whether there's a causal effect there.

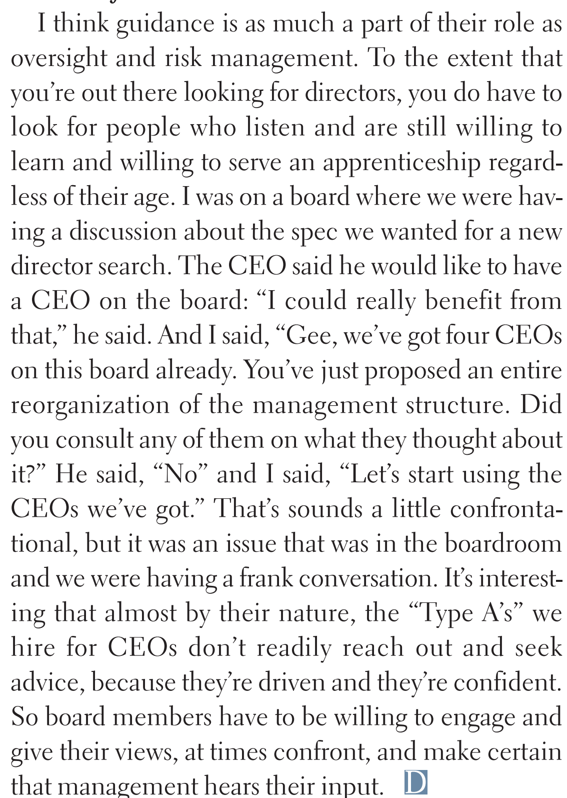
How about some of the proposed regulatory changes for boards, things like proxy access?

That will be very powerful—less so for activist investors and more so for mainstream investors. It will spur a massive self-help movement in corporate boardrooms. If we weren't already convinced that the model of the modern corporation is broken, if not bankrupt, then the events of the past few years had to tell us that, if not those from earlier in the decade when the most admired companies in the world collapsed before our eyes. As we struggle to think about how to improve our corporate governance regime, I can't find a better answer than to foster more involvement from the owners.

Should CEOs and boards focus on the broadest possible group of stakeholders?

I think they should stay focused on the long-term investors. If they get confused or try to make it too complex or think that they're serving multiple constituencies of their shareholder base, they will be led astray. What they really should focus on is the stock certificate. It's a very simple contract. When the owners are confident in the future, then everything else falls in place.

How should directors view their role today, if any differently than before?



I think guidance is as much a part of their role as oversight and risk management. To the extent that you're out there looking for directors, you do have to look for people who listen and are still willing to learn and willing to serve an apprenticeship regardless of their age. I was on a board where we were having a discussion about the spec we wanted for a new director search. The CEO said he would like to have a CEO on the board: "I could really benefit from that," he said. And I said, "Gee, we've got four CEOs on this board already. You've just proposed an entire reorganization of the management structure. Did you consult any of them on what they thought about it?" He said, "No" and I said, "Let's start using the CEOs we've got." That's sounds a little confrontational, but it was an issue that was in the boardroom and we were having a frank conversation. It's interesting that almost by their nature, the "Type A's" we hire for CEOs don't readily reach out and seek advice, because they're driven and they're confident. So board members have to be willing to engage and give their views, at times confront, and make certain that management hears their input. D

At a Glance

Relational Investors

Performance:
Relational Investors Composite 10.77% vs. S&P 500 Total Return Index of 5.06%, since inception on July 1, 1996 through August 31, 2009 (net, cumulative annualized).

Major Holdings:
(Largest to smallest)
- Home Depot
- Baxter International
- Genzyme Corp.
- Occidental Petroleum
- National Semiconductor
- Unum Group
- Precision Castparts
- Burlington Northern Santa Fe Corp.
- MetLife
- Freeport-McMoRan Copper & Gold Inc.
- Time Warner

THE INVESTORS

THE MEDIA

Ralph Whitworth and David Batchelder, Relational Investors

Pension fund group Relational Investors works to identify and nurture underperforming companies to the benefit of their investors, having in the past brought changes to Home Depot, Sprint, and other big-name companies. The firm's founders, **Ralph Whitworth** and **David Batchelder**, have led the fund through 13 years of consistent profitability, including a cumulative outperforming of the S&P 500 Total Return Index during this span. Whitworth, a veteran of public company boards, has formerly served as the chairman for Apria Healthcare and Waste Management. Batchelder has had a similarly prolific career as a director, having served on nine boards including Home Depot. (For an interview with Whitworth, see page 18.)

Ann Yerger and Amy Borrus, CII

Ann Yerger, executive director of the Council of Institutional Investors, an association of more than 130 public, labor, and corporate benefit plans with assets exceeding $3 trillion, has played an integral role promoting shareholder rights. Applauding the SEC's efforts to promote proxy access to shareholders, Yerger believes that additional proxy access allows "shareholders…to be more thoughtful about whom they nominate to serve as directors." Her colleague, deputy director and former *BusinessWeek* writer **Amy Borrus**, believes that boards should open the lines of communication to help shareholders "draw the link between performance and pay and address it head on."

THE MEDIA

Steve Forbes, *Forbes*

As the framework for American capitalism wobbled, the editor-in-chief of that lovably reliable list-making Capitalist Tool took center stage, authoring a cogent prescription for what ailed us and, in Oprah-like fashion, putting his own image on the Nov. 22, 2008 cover story, "How Capitalism Will Save Us." In it, Forbes argues for lower taxes, regulation that is prudent, not punitive, and a Federal Reserve that is committed to maintaining the dollar as good as gold. In addition to writing cover stories, Forbes is omnipresent in the privately held magazine and online fortress he both inherited and helped shape since being named president and CEO of Forbes, Inc., in 1990. His political interests are more than just that: In 1996 and 2000, Forbes sought the Republican nomination for the presidency and served as an economic advisor to presidential contender John McCain. Free people. Free markets. That's the Forbes mantra, as well as the shortest route to the top of his most cherished list.

Steve Forbes

Carol Loomis, Fortune

Fortune Senior Editor at Large **Carol J. Loomis** is a true veteran in the world of business journalism. A *Fortune* staff member for the past 52 years, Loomis has written profiles of all the major business leaders including Sandy Weill, Robert Rubin, and Warren Buffett. She has received every award in the business for her writing and involvement in business journalism, including the Women's Economic Round Table award, of which she was the first recipient. Other *Fortune* contributors to corporate governance: Editorial Director **Geoff Colvin**, whose newest book, *Talent is Overrated: What Really Separates World-Class Performers from Everybody Else*, will be published in October; and **William D. Cohan**, con-

CNBC: The Business Channel

As a co-anchor of CNBC's *Squawk Box*, **Becky Quick** addresses breaking financial news before most people have hit "snooze" a second time. Before assuming her current position, Quick was a Wall Street beat writer for CNBC. She has also been recognized for her retail and e-commerce beat at *The Wall Street Journal*. Warren Buffett tapped her to be one of his questioners at Berkshire Hathaway's most recent annual meeting. Quick's former Squawk Box co-anchor, **Maria Bartiromo**, is the anchor of CNBC's *Closing Bell with Maria Bartiromo* and the host and managing editor of *Wall Street Journal Report with Maria Bartiromo*, which was recently deemed the most watched financial news program in America. Other noted CNBC anchors include **Charlie Gasparino**, whose newest book, *The Sellout* (on sale Nov. 3, 2009), will indicate the guilty parties involved in last year's economic crisis; and **Jim Cramer**, formerly a hedge fund owner/manager, and, prior to that, a Harvard lawyer turned Goldman Sachs trader, who enthusiastically ends each day with his CNBC hit show *Mad Money*.