Evolving Roles of Corporate Governance

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Where in the chain of command does the responsibility of director's start and end? Owners need to see their needs met. If Boards fail to do so then the boards will need to cede that power to the owners.

Can owners governance needs be satisfied if directors become strategic partners to management? Authority still cascades from owners to directors to management.
What is a strategic partnership? How does that relate to the widely accepted idea that directors can only represent the interests of owners by being independent of management?

Will a strategic partnership once again blur accountability leading inevitably back to the same issues that have been repeatedly witnessed in public companies: failures, even catastrophic failures, that arise, not from taking prudent business risks, but from taking risks that benefit management, perhaps even directors, but are seldom in the interests of owners. This is a failure you seldom see in private companies because there is little separation between owners and directors.

I will first touch on Teachers approach to corporate governance. What are some of the issues that we currently see gathering strength in proxy seasons?

I believe Teachers as an owner is well known for its leadership in the corporate governance arena. We formulated and published our original governance policies in 1991. We were founders of the CCGG, and active in the Global Institutional Governance Network, PIAC, ICPM, and the ICGN including our plans to sponsor their 2010 conference in Toronto. Indeed, we have also be fully supportive of the activities of the ICD.

Our investment strategy and therefore our governance involvement, has transcended private equity, public equity, relationship and activist investing as well as index funds. We have always chosen to have a visible spokesperson that is vocal about our positions on governance.

We are currently the sole owner of Glass Lewis LLC, one of the worlds' leading providers of governance and proxy research on companies worldwide. Glass Lewis has an advisory body to set governance policy independent of Teachers'.

We are also active sponsors of governance research including the study done annually by Rotman School of Management on pay for performance.

Teachers' walks the talk.

Governance is the system by which corporations are directed, controlled and evaluated. Share ownership entitles the shareholder to a portion of the income of the company and

to net proceeds in the event of a windup. Shareholders have a right and a duty to vote their shares, the right to information about the company and the right to express an opinion about the company.
At Teachers', we have developed our corporate governance and proxy voting guidelines keeping in mind our fiduciary responsibilities to our members and our rights as owners. It is inconsistent from a fiduciary perspective to approve proxy initiatives that we believe likely to diminish shareholder value in the long run.

With all of our governance and proxy actions we try to be pragmatic and apply the guidelines we have developed with thought and consideration for the circumstances companies find themselves in.

During our voting process we will contact the company directly with our concerns in an attempt to discuss proposals, to request modifications to proposals or to sometimes ask that a proposal be withdrawn. The sooner we have become involved in that process the easier it has been to resolve most issues to the satisfaction of all.

Directors play the most significant role in the governance of any company. We believe that directors must represent all shareholders, particularly within public companies, and not just a majority.

Boards must organize themselves' to constructively challenge management's recommendations and to evaluate corporate performance from an objective perspective. Performing that role leads to the demand they be independent on the part of investors and owners.

Our governance guidelines state that Boards need the freedom and the flexibility to organize in the manner that is best for the individual company. As such we do not generally support proxy proposals that would put additional constraints on boards in order to fulfill their duties such as term limits or diversity criteria in the nominating process.

We understand that what we really need is not only functional processes that make boards look independent but we need to have board members that are of an independent mind from management. Maybe you will know an independent director when we see one.

Directors have a separate role to play in governance. In public companies they represent the owners. They are not part of the management team. The more they stray from that path the more they will naturally cede what has normally been a director's prerogative to either the owners or to management.

From an owner's perspective the independence of mind for a director needs to be demonstrable or it won't be perceived to exist and will not lead to the necessary level of trust in the relationship. In the relationship between directors and owners an independent mind set can best be demonstrated through candid dialogue and the use of full and understandable disclosure of the affairs of the corporation.

Teachers' started down the governance path largely because we had large stock index positions that we intended to hold for a long time. We felt that the best way to influence the outcomes positively was through improving the governance process. Initially as shareholders we were largely outcasts in the governance process.

Often the communications constraints placed on public issuers by the capital market regulators to protect minority shareholders were also a large impediment to progress. Those barriers have been softened so that it is now easier to facilitate communication between shareholders and shareholders and directors.

We made slow and steady progress in defining and then asserting our role. Then the Enron-type scandals in the U.S. changed the relationship dramatically. Clear notice was given to directors by both owners and more importantly by regulators that the status quo was no longer sustainable.

The dominant governance driver at Teachers' is the use of director independence to eliminate the misalignment of objectives and the subsequent agency costs that arise from them. We believe that an independent director has a state of mind formed both by the right expertise and the will to act.

Let me briefly visit a current issue to demonstrate that governance issues have not gone away.

You've heard of AIG. If you haven't then you haven't been reading the papers or listening to the news. The company had been in a protracted battle, stretching back years, with its shareholders over misleading financial statements and as an offshoot the appointment of directors.

Indeed the company funded, using shareholders money, a protracted court battle against its' own shareholders attempts to overhaul the board. AIG is also the target of class action lawsuits, of which OTPP is a plaintiff, regarding misleading disclosure on its' financial statements.

The case is not yet in court and now may never get there. Ultimately the CEO, under whose watch the allegations were alleged was ejected, parachute in hand. Much to the objection of long suffering shareholders, he was replaced by the 2IC at the time.

That replacement was then also replaced as the liquidity crisis unfolded with a further severance package of about $47 million. The company has now been taken over by the U.S. Federal government in order to save the world finance and banking systems at an estimated cost of up to $ 80 billion. Share values may be worth only a fraction of their original value if anything. The failure was likely caused by a very small portion of the assets of the company but also the very ones whose disclosure shareholders have complained about for a very long time.

The rating agencies, the regulators, the New York attorney general, the auditors and all others failed to stop the slide into disaster. In my mind shareholders were there, in advance, but had insufficient power to act and prevent the disaster. As you listen to the debate in congress, other than the cost for that failure to act we all know what the outcome will now be: regulation, more regulation and even more regulation.

AIG is likely a company whose directors met the independence standards but not an independent state of mind. The board did not act to prevent the failure and more particularly they were unwilling to communicate candidly with their shareholders and took strenuous effort to prevent owners from acting.

Yes, AIG was caught in a credit maelstrom but it was also a colossal governance failure. The level of trust amongst long term shareholders of AIG had plummeted long before the credit markets leaving AIG to the mercy of short term holders and short sellers.

I would like to spend a few minutes talking about three current issues that are uppermost on the proxy agenda this year.

First, the issue of majority voting. Teachers' supports the idea of a majority vote standard for the election of directors including the right to vote for directors individually rather than as a slate. Companies worldwide are starting to adopt that standard.

We would treat the election of directors akin to a hiring decision. It might be useful for shareholders to issue questionnaires to directors in advance asking questions pertaining to their functional independence and their attitudes to governance. It might be useful to make nominees available for follow up calls or interviews with interested shareholders.

Our second hot topic for the upcoming year is 'Say on Pay'. This issue has gained a lot of traction in Europe and the U.S. 'Say on Pay' is usually characterized as a non-binding advisory vote on a company's compensation report.

Since AFLEK agreed in the U.S., a further nine majors have agreed to hold non-binding votes on compensation. Even in Canada, CIBC received a 45% vote in favor on its proxy ballot.

At Teachers', we are not normally supportive of 'Say on Pay' because we believe this action tends to encroach on matters that can be better dealt with by the board of directors. On this issue, we believe it is more effective to engage boards in dialogue and only when improvements are not forth coming to vote against the compensation committee members.

CCGG is of a similar mind and does not recommend further regulation in this matter. They believe that the upcoming CSA rules on compensation disclosure will have significant impact on the issue. CCGG also notes that the Rotman scoring, sponsored in part by Teachers', has shown a clear trend to improvement in this category.

The final area which is perennially on numerous proxy ballots are the "ES" part of ESG. Environmental and social issues range from global warming to sexual orientation. Again we do not generally support such issues because they seek to alter the responsibilities of directors to supervise management. We do encourage companies to develop policies that address this issue. This appears to be a fruitful area where the board can have meaningful input into corporate strategies to ensure the inclusion of reviews for sustainability and morality. These are subjects that need to be built into vision and strategies.

In summary, the reason that corporations exist is to allow owners of capital to undertake business risks. Directors are only human. Shareholders need to expect that companies will sometimes fail in their business decisions.

Judgment and candor are what directors can bring to the table. A candid discussion with management to make sure they know where the corporation is going, the risks that entails and then to bring their judgment to bear on that strategy to increase its' likelihood of success. The communication of those actions in a clear and understandable format will enhance the level of trust between the board and owners. With trust, the corporation can pursue long term objectives with the full support of its shareholders.

Thank you.