



A DIRECTOR'S PERSPECTIVE...

Improving Corporate Governance: A Memo to the Board

Corporate directors are doing a much better job than they get credit for, but here are a few suggestions for improvement.

By [JOHN J. BRENNAN](#) as published in the May 10, 2010 Wall Street Journal.

It is corporate proxy season, and one can expect the usual spate of stories about excessive executive compensation, lax directors and the failure of institutional investors to exert their influence over boards and management.

As a participant in the corporate governance process for a large investment manager for more than 25 years, I will take a contrary view. Over the past quarter-century, the performance of corporate boards has improved markedly. Yet there's room to go.

As one of the largest index fund providers in the world, Vanguard is, at a minimum, a 2% owner of just about every public company in the United States. While a large portion of the firm's assets are managed using a passive approach, the company hardly takes a passive approach to corporate governance. Vanguard is among the permanent shareholders of corporations, with a shared interest in maximizing long-term value, not in meeting short-term goals such as quarterly earnings and yearly stock-price gains.

Here are a few suggestions to keep corporate board improvement continuing:

1) *Know that you are the shareholders' first line of defense.* You are our hands-on supervisors of the management team. You are the individuals we rely on to ensure that the capital we've invested is well-stewarded. Permanent shareholders simply cannot, nor do they want to, get involved with the management of companies. As a result, their focus is on you, the members of the board; on your qualifications and character; and on your level of engagement with your owners.

2) *Build value through mutual respect.* All stockholders should respect the people who put the time and energy into governing public companies. In turn, you must respect your stockholders; not just tolerate us, but truly respect us, since we've tied our financial well-being to your success as a director and a management team. Always remember: It's not "your" company. There is an unfortunate supposition today among some regulators and much of the press that the relationship between stockholders and boards should be confrontational rather than collaborative. I simply do not believe that is a healthy or effective way to build value for people who supply capital.

3) *Communicate.* Great boards of directors listen and hear. They reach out to their most important shareholders for input on critical policy decisions, such as compensation structure or takeover defenses. Communication should be ongoing and consistent, not episodic or solely in the face of a crisis. Effective shareholder relations programs take care and feeding, and they mature over time.

4) *Measure your success.* Great boards are self-reflective and self-evaluating. Importantly, the appropriate measures are not simply stock price, earnings or cash flow for the trailing 12 months. Real, long-term success is about other things—such as succession planning, strategy, big-picture goals.

Now let's move from the conceptual to the concrete. Boards can further strengthen the governance process by adopting the following practices:

5) *Compensate yourselves in equity.* Paying directors predominantly in equity aligns the interests of the board to those of the permanent shareholders. I would suggest that every director of a public company should be required to hold a minimum of, say, five years' worth of his board pay in the form of company stock from the first day he joins the board and hold those shares until he or she leaves the board. An alternative would be for all compensation to be paid in stock (no cash) and required to be held until a director reaches the target ownership level.

6) *Share your metrics.* Stockholders already get a detailed report on how boards evaluate the CEO and management team through their pay. Boards should produce a similar (if less-detailed) document on how they evaluate themselves on the important measures outlined previously.

7) *Hold yourselves accountable.* Most boards would agree that the appointment and oversight of the CEO is the most critical function they perform. Recognizing that there are important implementation challenges, I'd suggest that directors be subject to clawbacks on pay if they fail to oversee an orderly transition in leadership.

8) *Establish an "owner's relations committee."* Similar to the compensation or audit committee, a group of directors should be charged with engaging the company's serious, long-term stockholders on a regular, meaningful and candid basis. Think about it: If you had only one owner of a private company, the board would be in contact constantly. Why not take the same approach, especially with your best shareholders who have been, and will be, with you through good times and bad.

Some boards already embrace these concepts. In fact, one of the most significant changes I've observed over the past two and a half decades has been a great attitudinal shift in boards away from doing what is right for the insiders to doing what is right for the shareholders. Importantly, this cultural change has been driven by board members themselves.

It is in this same manner that boards will adopt these best practices and make them standard operating procedure. Not by regulation nor by legislation, but by leading directors and leading boards leading the way.

Mr. Brennan is chairman emeritus of Vanguard. This is based on a recent speech at the Drexel University LeBow College of Business Center for Corporate Governance.

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