When the world's largest financial institutions had to be rescued from insolvency in 2008 by massive injections of governmental assistance, many blamed corporate boards for a lack of oversight.

This was a problem we had supposedly solved nearly a decade ago, when blatant failures of corporate governance (remember Enron?) prompted Congress to pass the Sarbanes-Oxley Act. The new rules had seemed promising. The majority of a board's directors had to be independent, which would, in theory, better protect shareholders. Senior executives were required to conduct annual assessments of their internal controls for review by external auditors, whose work would be further reviewed by a quasi-governmental oversight board.

The recent financial meltdown, however, has made it clear that the new rules were insufficient. Most major financial institutions in 2008 were more than compliant with SOX. Indeed, at the banks that collapsed, 80% of the board members were independent, as were all members of their audit, com tion, and nominating committees. All the firn evaluated their internal controls yearly, and th reports from their external auditors showed ı terial weaknesses in those controls. But that stop the failures.

Why were the SOX reforms so ineffective? view, they merely added a new layer of legal tions to the job of governance without improvi quality of people serving on the boards or chа their behavioral dynamics (with one exceptic "Executive Sessions: A Reform That Works").

I've been the president or chairman of two financial firms, an independent director of s large industrial companies, and a longtime s of corporate governance. During my career, I'v several chronic deficiencies in corporate b Boards are often too large to operate effectiv decision-making groups. Members frequent sufficient expertise in the relevant industry most important, few members devote the needed to fully understand the complexities company's global operations. In the following I present a new model for corporate governan

Introducing the Professional Boar

I propose a model of professional direct that directly responds to the three ma tors behind ineffective decision maki this model, all boards would be limi size to seven people. Management wo represented by the CEO, and the other six dir would be independent. Most of the indepe directors would be required to have extens pertise in the company's lines of business, an would spend at least two days a month on co business beyond the regular board meetings.

Smaller size. Many of the financial instit that failed in 2008 had very large boards, and a substantial majority of independent directo group, for example, had 18 directors, of whom 1 independent. Boards as large as this are comn the financial sector. Industrial companies t

The Citigroup board was filled with luminaries from mar walks of life. Yet in early 2008 only one of the independe directors had ever worked at a financial services firm.

Idea in Brief

The model for corporate governance is broken. Despite having boards crammed with eminent independent directors following detailed procedures, many of the world's largest financial institutions had to be rescued from insolvency in 2008.

Insufficient board oversight is a problem that was supposedly solved in 2002, with the passage of the famous Sarbanes-Oxley Act. Yet all the firms that failed in 2008 were SOX compliant.

The reforms did little to improve the quality of people serving on boards or change their behavioral dynamics.

To improve governance, companies need to move to a model of professional directorship: Board service would be the primary occupation of independent directors, and not an ancillary avocation. The new model would address chronic deficiencies of corporate governance by taking the following measures:

- Reduce board size to seven members to improve decision-making effectiveness;
- Require that most directors have industry expertise to allow them to better guide today's complex businesses;
- Require directors to devote sufficient time to properly understand and monitor the company's operations.

have somewhat smaller boards—the average size for S&P 500 companies was almost 11 in 2009, according to recruitment consultants Spencer Stuart.

But even 11 directors are too many for effective decision making. In groups this large, members engage in what psychologists call "social loafing": They cease to take personal responsibility for the group's actions and rely on others to take the lead. Large groups also inhibit consensus building, which is the way boards typically operate: The more members there are, the harder it is to reach agreement, and so fewer decisive actions are taken.

Research on group dynamics suggests that groups of six or seven are the most effective at decision making. They're small enough for all members to take personal responsibility for the group's actions, and they can usually reach a consensus in a reasonably short time. In my opinion, these advantages of small size outweigh the potential benefits of having extra generalists on a large corporate board.

The six independent directors called for in the new model are sufficient to populate the three key committees: audit, compensation, and nominating. Three different directors would serve solely as chairs of each of those committees, and the other three directors would each serve on two of them.

Greater expertise. The Citigroup board was filled with luminaries from many walks of life—it boasted directors from a chemical company, a telecom giant, and a liberal arts university, for example. Yet in early 2008 only one of the independent directors had ever worked at a financial services firm—and that person was concurrently the CEO of a large entertainment firm. Of course, every board needs a generalist to provide a broad perspective on the company's strategy, and also an accounting expert to head the audit committee. The other members, however, should be experts in the company's main line of business.

Lack of expertise among directors is a perennial problem. Most directors of large companies struggle to properly understand the business. Today's companies are engaged in wide-ranging operations, do business in far-flung locations with global partners, and operate within complex political and economic environments. Some businesses, retailing, for one, are relatively easy to fathom, but others—aircraft manufacture, drug discovery, financial services, and telecommunications, for instance—are technically very challenging. I remember catching up with a friend who had served for many years as an independent

> "I thought I knew a lot about the company," said one director, "but boy, was I wrong."

director of a technology company. The CEO had suddenly resigned, and my friend was asked to step in. "I thought I knew a lot about the company, but boy, was I wrong," he told me. "The knowledge gaps between the directors and the executives are huge."

To close those gaps, large companies need independent directors who have the expertise to properly evaluate the information they get from managers. Perhaps more important, the directors must know what questions to ask about information they are *not* getting. Consider Medco, a pharmaceutical benefit manager (PBM). When it was owned by drug giant Merck, Medco recognized as revenue the drug copayments made by patients, although the company never owned those payments but merely processed them and passed them through to the health insurer. The distinguished directors on Merck's audit committee were generally unaware of this practice until Merck tried to sell some shares to the

EXECUTIVE SESSIONS

A Reform That Works

In 2003, the SEC approved some additional governance standards for public U.S. companies. One of them—the requirement that the independent directors of all listed companies meet regularly in executive session without management present—represents a significant improvement in board oversight.

At these sessions, independent directors are able to candidly discuss controversial issues facing the company. Some issues involve the CEO personally—his or her compensation, leadership strengths and weaknesses, or succession strategy. Others are broader, such as legal allegations against the company, potential changes in control, or dissatisfaction among members with how the board operates.

When the CEO is present, many independent directors are reluctant to raise concerns about his or her competence or tenure. They may also refrain from complaining strenuously about the company's handling of important issues. The unwritten rules in many

public. If any of the independent directors had been experts in the field, they would have known that some PBMs recognize revenue this way and could have evaluated the appropriateness—and potential pitfalls—of the practice for Merck.

Indeed, a firm's audit committee should insist that the external auditors identify any significant accounting policies that depart from standard industry practice or for which the accounting literature allows alternative treatments. In either case, the external auditors should provide the committee with a careful analysis of the risks and benefits of available alternatives.

Increased time commitment. In the years before the financial crisis, the Citigroup board generally met in person seven times a year, for a full day each time. They also had a number of telephone meetings, each lasting a few hours. Factoring in some time for reading materials in advance of these meetings, let's estimate roughly that the independent director of Citigroup might have spent, on average, 200 hours a year on board business, excluding travel time. Was this enough time to understand the operations of a complex global firm like Citigroup? The answer is obviously no.

Even a director with banking experience would need to spend at least two days a month, in addition to regular Citigroup board meetings, keeping abreast of company business if he were to contribute meaningfully to the board. And two days per month was, in fact, precisely the time commitment made by the head of the audit committee for one of Canada's largest companies, on whose board I also served. A retired accountant, this board colleague visited the company's offices relatively frequently. While he gave management advance notice of his visits, he talked informally with people at different levels in the finance function. He soon had a firm grasp of the company's financial operation and made sure that all material issues came before the audit committee. For the first time, the audit committee members began "to know what we didn't know," to paraphrase former U.S. Defense Secretary Donald Rumsfeld.

Independent directors of large companies sometimes assert that they have particular insight into the firms' operations because the board holds one meeting each year at one of the company's major facilities, rather than at headquarters. As a former company president who has hosted these field trips, I am skeptical. The employees interviewed by the independent directors on site are usually well rehearsed. If trips go as planned, the directors hear and see what management wants them to hear and see.

There's no way around it: Directors must invest significantly more time than they currently do learning the business and monitoring internal developments and external circumstances that affect the company. Of course, more time spent on one company's business means less time available to devote to other boards. Independent directors, who are now allowed to serve on the boards of four or five public companies, should be restricted to just two. (This should not prevent them from serving on nonprofit boards.)

What this all adds up to is a new class of professional directors with the industry expertise and the time commitment necessary to understand and monitor large public companies effectively. Board service would not be a sideshow in their professional lives; it would be the main event.

The Likely Hurdles Facing Professional Directors

professional-director model is a significant departure from current board process under SOX and from the relevant sections of the Financial Reform Act, which generally

boardrooms call for a polite tone, understated language, and indirect criticism.

All this reluctance goes out the window in executive sessions. Without the social constraint of management's presence, independent directors can express strong opinions in blunt language. They can engage in honest debate about the company's deficiencies and explore a broad range of potential solutions, even drastic ones.

I would propose that the rule be taken even further: Independent directors should meet in executive session before every board meeting to discuss the issues at hand and meet again, if necessary, at the end of the board meeting to agree on next steps. The lead director or nonexecutive chair should communicate to the CEO the key takeaways from the executive session.

reinforce the SOX approach (see the sidebar "The New U.S. Reforms Won't Change Much"). As a consequence, it is likely to elicit practical and legal objections. Let's look at the four most significant ones.

Professional directors would be hard to find. Finding independent directors with relevant professional expertise will not be easy; the most-qualified people will be working for the company's competitors, making them unsuitable despite their expertise. Moreover, any executive running a large company will not have enough time to serve as a professional director.

As a result, most independent directors will be retired executives (but not former executives of the company in question). This pool of candidates is reasonably large: Male and female executives often retire around age 60 in good health but want to continue to work, preferably on a part-time basis. For them, the role of professional independent director is a perfect fit. After all, who really wants to play golf every day for 25 or 30 years?

Recruiting professional directors primarily from the ranks of retired executives should go hand in hand with an end to mandatory retirement at age 70 or 72. Mandatory retirement is simply a device that lets boards avoid the difficult process of evaluating directors; instead, they are automatically kicked out at a specified age. This is a terrible waste of talent—some directors do a great job at 75, and others sleep through meetings at 65.

If we want directors who truly understand the company's business, they should be allowed to serve as long as they pull their weight. Rather than enforce blanket retirements, boards must undertake the hard work of evaluating directors' performance on an individual basis. To help structure the process of evaluation, the board could require all directors to submit their resignation yearly, starting at age 72. If they wish to continue, they would also submit a letter explaining why they believe they could contribute significantly in the coming year.

They would be too expensive. Professional directors would be working a lot harder than directors do today—putting in roughly twice the hours. In addition, they'd be limited to serving on two for-profit boards. It is only reasonable, therefore, to accord professional directors a total compensation of approximately $400,000 a year—nearly double the current average annual compensation of $213,000 for directors of S&P 500 companies. Expensive as it sounds, this would not increase the company's total board compensation outlays by much, since there would be only six independent directors to pay, not 10, 12, or even 16.

For executive retirees, the role of professional director is a perfect fit. After all, who really wants to play golf every day for 25 years?

The more challenging issue is determining the composition of that $400,000. Directors of S&P 500 companies receive, on average, 58% of their compensation in restricted shares and stock options and the remainder in cash or benefits. I agree that professional directors should be paid more in shares than in cash to better align their interests with those of long-term shareholders; in fact, I recommend increasing the stock-based proportion to 75%.

Many former executives are already wealthy; their motivation to be an independent director is often personal and professional satisfaction rather than monetary rewards. That mind-set naturally orients directors toward taking a long-term perspective.

The New U.S. Reforms Won't Change Much

Tucked into the 2,400 pages of the recent U.S. financial-reform legislation known as the Dodd-Frank Law are a few sections on governance procedures, which apply to all publicly held companies and not just financial institutions. These sections address three areas of governance: board functions, enhanced disclosure, and shareholder rights. But apart from some new requirements for nonbinding shareholder votes, they are mainly elaborations or confirmations of existing rules.

Board Functions

All public companies must provide for clawbacks of compensation paid to current or former executives if the amounts were based on erroneous company financials. This mandate expands the clawback provisions of SOX, which apply only to the top five executive officers of public companies, and eliminates SOX's condition of executive misconduct for clawbacks. Moreover, all members of a board's compensation committee must be independent, as defined by the SEC. Independence from a separate compensation committee is already required per the listing standards of the U.S. stock markets.

Compensation committees may select a compensation consultant or other adviser only

Nevertheless, I would reinforce that viewpoint by making any grants of restricted shares and stock options subject to two conditions. First, they would vest in equal parts over four years. Second, at least half of all shares granted (including any shares acquired through exercising options) would have to be held until the director's retirement from the board. (Directors should be able to sell the other half to pay the taxes due on shares as they vest and on options as they are exercised.)

Since the passage of SOX, companies have increasingly granted restricted shares rather than stock options. Stock options incent directors to boost the stock price for short time periods, the argument goes, so that they can exercise their options and immediately sell the shares acquired. But this short-term approach would be severely limited by the two

Far from telling employees what to do, the role of professional director is to identify material issues that should be considered by the board.

conditions above. Moreover, I believe that stock options do a much better job than restricted shares of aligning the interests of directors and shareholders. If a company's share price falls by 10%, the restricted shares lose only 10% of their worth and directors still retain considerable economic value. Restricted shares are effectively a form of deferred cash payment, with a modest equity kicker. By contrast, if the share price falls by 10%, stock options are worthless.

They would not want a role that increased their legal exposure. One could argue that because professional directors will actively supervise the company's operations, they will be subject to increased legal liabilities if something goes wrong. For example, if the head of the audit committee takes the lead in monitoring a company's financial function, will he or she be more liable than other directors if the financial statements contain material misrepresentations? The answer is definitely no, unless, of course, it can be shown that the audit head knew of the misrepresentations.

When courts review the actions or inactions of corporate boards, the threshold test for personal liability is whether the directors were independent. Under the new model, this will unquestionably be the case. And in instances where directors are truly independent, American courts defer heavily to boards' business judgment about what is in the best interest of their companies. In other words, courts tend not to hold independent directors liable for a wrong decision, even if the company lost billions of dollars as a result. The courts absolved even the independent directors of Citigroup from personal liability, despite the firm's huge losses during the financial crisis.

In general, courts penalize independent directors only if they are deemed not to have acted in good faith: They did not carefully consider all the factual and legal issues; they neglected to obtain advice from independent experts if needed; or they deliberated for insufficient time to make a reasoned decision. Because professional directors will spend more time on due diligence than today's norm, they will actually be in a stronger position to show that they acted in good faith.

Finally, it bears emphasis that independent directors, even if professional, would be held liable only for a material misrepresentation (or omission) that they knew about or recklessly disregarded. Directors are not held liable in class action suits if

after they have considered certain factors, including the independence of the adviser.

Enhanced Disclosures
Compensation committees must publicly disclose any conflicts of interest involving a compensation consultant advising the board. The company must also publicly explain why the board is chaired by the CEO, if that is the case. Both disclosure rules follow existing SEC requirements.

All public companies must, for the first time, disclose the ratio between the CEO's compensation and the median compensation of the company's other employees.

Shareholder Rights
At least once every three years, shareholders must vote on the compensation of a public company's top executive officers. The vote is advisory—it is not legally binding on the board or the company.

If shareholders must vote to approve a merger or acquisition, they must also vote on any "golden parachute" or termination payments related to the transaction—unless such payments were subject to a previous advisory vote. This is a nonbinding, advisory vote.

Finally, the legislation confirms the SEC's authority to adopt rules on proxy access—allowing shareholder nominees for directors to be included on the company's proxy card along with management's slate of nominees.

they could have or should have known about the misrepresentation.

They would meddle in operations. Probably the most serious objection to my model is that it might blur the distinction between the roles of the board and management—or in the European context, the roles of the supervisory and management boards. A board of directors is supposed to set strategic goals for the company and monitor its progress against those goals. It has relatively well-defined duties in specified areas such as CEO succession, appointing the external auditor, and responding to takeover bids—but it is not supposed to get involved in day-to-day management.

Although the new model would entail some reallocation of power from senior executives to professional directors, it would not require directors to oversee day-to-day operations. Imagine an audit committee under the new arrangement. Like most audit committees today, it would meet quarterly to review financial filings and press releases. The committee would also meet to review the annual evaluation of internal controls. It would hold private discussions with the external and internal auditors, the chief financial officer, and the chief compliance officer. But under the new model, professional directors would also spend a significant amount of time gathering information throughout the year, engaging with company staff and others between board meetings. Through these discussions, professional directors would understand the company's financial issues much better than they could by sitting through a three-hour audit committee meeting each quarter. Far from telling employees what to do or not do, professional directors would simply be trying to identify material financial issues that should be brought before the committee for review and decision.

Consider also the role of the compensation committee under the new model. As they do presently, the directors would set the CEO's compensation and review the compensation plans of senior officers. The directors would also approve a report explaining the rationale of the company's compensation plans, for inclusion in the annual proxy statement. In addition, professional directors would spend more time with experts so as to educate themselves on how the company's compensation plans stack up against those of other firms in the same industry or of comparable size. Between board meetings they would talk with managers and HR officers to get a better grasp of employee reactions to the company's compensation policies. In these sessions, however, the professional directors would not get involved in the evaluation of the performance or pay of any individual employee or specific group of employees—these subjects would be strictly out of bounds. Instead, the sessions would be aimed at putting the professional directors in a better position to help design and assess the compensation plans of the company.

Of course, each company would be free to craft the exact nature of the professional directors' role in accordance with the size and scope of the business. In fact, almost any allocation of roles between directors and management is permissible in the United States under the current legal framework—the same is true in most free-market countries.

Getting Started

Those who agree that the new model is superior might be wondering how public companies could be persuaded to adopt it. Few CEOs would voluntarily embrace any scenario that shifts a significant degree of power from management to the board. When I was the head of an investment management firm, I was certainly not interested in cultivating a more activist board with directors who

To improve corporate oversight we need not more legal procedures but a new culture of governance in which directors commit to the role as their primary occupation.

would regularly identify thorny issues for the board to consider.

One of three things, therefore, will have to happen if we are to get companies to adopt the new model. First, government regulators could require large banks to adopt it as a matter of safety and soundness under banking laws. If bank directors are to constrain management from taking excessive risks, they must have extensive financial experience and spend considerable time between board meetings on bank business. To some extent we are already seeing a change in this direction in the financial sector. U.S. regulators leaned heavily on Citigroup and other large banks to replace generalist directors with retired banking executives in the wake of the financial crisis. Second, shareholders could join together to pressure a company into adopting the new model. Under the recently enacted SEC rules, large shareholders now have the right to have their director nominees included on management's proxy cards, and these shareholders could nominate directors who support the new model. Large companies with records of chronic underperformance could benefit most from an influx of professional directors and would be a good place for shareholder campaigns to focus.

Finally, a few brave and confident CEOs of sound companies might actually be willing to try out the new model. We've seen important changes from the corner office before: The practice of majority voting started from the initiatives of a few enlightened CEOs. If experiments with the new model were to generate higher earnings or stock prices for the companies involved, then I would expect the new model to spread.

"I think we're in good enough shape to start making the same mistakes again."

SOX AND the recent financial reform legislation were largely written by lawyers who tried to solve the perceived problems by creating more detailed procedures for boards to follow. To be sure, some of the rules are reasonable, but they do not address the key challenges in improving corporate boards: recruiting very intelligent people with deep industry experience and getting them to commit the time needed to truly understand and effectively monitor the complex activities of a large public company.

To accomplish those goals, we need not another layer of legal procedures but a new culture of governance, one in which professional directors view their role as their primary occupation. In this culture, they will gather enough information to ask all the questions that should be asked and not rest until they have received satisfactory answers.

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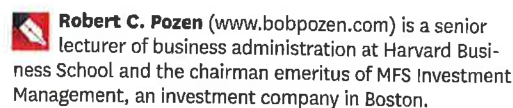
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