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Q2 Fall 2007

Can we manage with(out) markets?

Yale School of Management

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A Publication of the Yale School of Management

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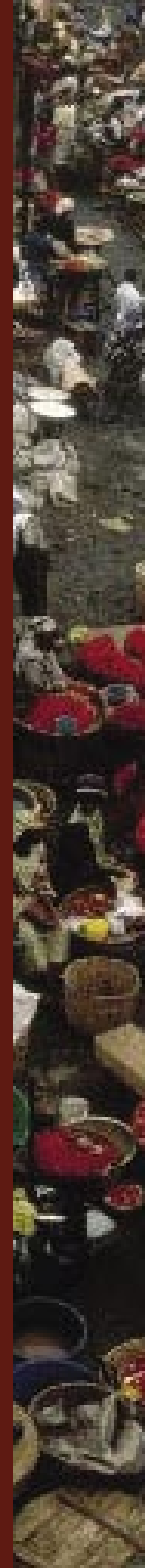
Cover photograph by Tony Rinaldo



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Concept and design 2x4

Q(n), a publication of the Yale School of Management, is published twice a year under the auspices of the Dean, Yale School of Management.

Q2 is a magazine of opinion. The views expressed in *Q2* are the views of the authors and contributors, and do not reflect the views of the Yale School of Management.

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Printed on 100% recycled, postconsumer-waste paper. The greenhouse gas emissions associated with the production of this magazine have been offset through the purchase of renewable energy certificates. *Q2* was typeset in American Typewriter, DTL Elzevir, and Swiss fonts.

Back cover photograph by Tony Rinaldo

How can directors become truly independent?

Joseph S. Fichera proposes an innovative way to make corporate directors more independent and effective by providing them with better information.

The current national commitment to strengthening responsible corporate governance has been born in scandal, mandated by law, endorsed by influential leaders, and ratified by public opinion. The reform impulse has been especially notable in the changing role of independent directors. They are now more immersed in administrative, regulatory, and financial detail, expend more time and energy in board committee work, and otherwise perform an array of oversight functions beyond the ken of their immediate predecessors. This heightened level of participation has often had the salutary effect, for example, of promoting the integrity of legal advice and accounting conventions. In many areas, however, the capacity of boards to follow through on their responsibility has been hampered by institutional constraints which compel them to rely almost wholly on management as a source of facts and analyses which may be designed primarily to persuade rather than inform.

If boards are to maximize the benefits of their expanded role they will require access to additional sources of data and interpretation well beyond those that are now available to them. There are a number of competing organizational strategies for achieving this outcome: (1) the board, singly and collectively, in addition to its other duties, could charge itself with generating such information as deemed appropriate; (2) the board could, on occasion, seek the advice of consultants with specialized knowledge outside the scope of the board's own expertise; (3) the board could appoint its own company-employed, in-house staff which would monitor and augment information transmitted by management; (4) in view of the manifest limitations of any of these approaches, the best alternative could be the creation of an independent agency that is free from any conflicts of interest, actual or perceived, and hence dedicated solely to providing directors with accurate, valid, and reliable knowledge about the range of issues over which they preside.

Joseph S. Fichera '82
CEO, Saber Partners, LLC

The Board as Provider

Directors already are required to digest an array of presentations and data when the board is in session and to absorb numerous pages of reports between meetings. As prominent citizens with diverse interests and obligations, they can seldom spare the time to mine the literature emanating from Wall Street, the campuses, and think tanks, or to master the intricacies of research methodology or research findings in sufficient depth to address such issues as Wall Street's impressions, rating agency views, information technology, finance, operations, and the competitive landscape, to name only a few. Given the growing burdens of board membership, it would be both unrealistic and harsh to assign directors the daunting task of generating the requisite information to enable independent judgment.

The Board and Consultants

At present, the flow of information circulated to directors is mainly provided and controlled by management and reflects management's distinctive perspectives, with the result that meetings of the board are often reduced to a series of presentations before an expert audience but one that has not been fully exposed to the immediate and imminent financial, organizational, and ethical issues confronting the company and its industry. Boards intermittently engage consultants "as needed" — e.g., bankers who address the economic consequences of proposed mergers and acquisitions, auditors who evaluate the existing system of financial reporting and control (now chosen and employed directly by the board's audit committee), compensation experts on executive pay, and attorneys who alert directors how to comply with newly enacted regulations and legislation. These are often fruitful — indeed indispensable — ad hoc relationships, but they are no substitute for a permanent complement of "on-hand" advisors who identify the board as their client. Consultants ordinarily are engaged in response to crises, address narrowly defined issues, and do not provide the larger context for the board's continuing responsibilities.

The Board and Its Own In-House Staff

Any arrangement that provides independent information to directors is better than none. That being said, there is good reason to reject the seemingly straightforward but unrealistic solution of assigning this function to an in-house staff that would be answerable to the board. An in-house staff that was truly independent from management would require too much oversight by the board. If, on the other hand, the staff were administered by management, the staff would lose its independence, creating conflicting lines of authority and career paths, as well as other potential conflicts of interest.

The Board and External Resources

In view of the clear limitations of other approaches to serving corporate directors, it may be time to think of changing the organizational support given to boards. New institutions could be created (profit-making or not-for-profit corporations) that could act as the external research-and-information arm of corporate boards and serve as an ongoing, independent, objective, and neutral source of data and analysis as these become relevant in the course of the board's deliberations on company strategies and policies. A new corporate "best practice" could be made possible by assembling a group of distinguished advisors and staff for the purpose of establishing permanent organizations, large or small, dedicated to providing directors of multiple companies with the requisite knowledge base for effective corporate governance on an ongoing basis. These external resources would be free of a conflict of interest since they would not serve management or other intermediaries but only directors.

There are a variety of ways the board could disseminate the reports of its independent, external research group as the situation warrants. It could consider them in camera or, as is much more likely, the directors might prefer that most discussions be collaborative, and that staff could be asked to review much of its work in a joint discussion with the board and management.

The creation of a new profession devoted to the interests of independent directors would not infringe on the oversight responsibilities of the board or the operational functions of management. It rather would perform functions that benefit all sectors of the enterprise. For board members, this fundamental structural change would have the incidental effect of reducing pervasive anxieties about limited time, personal liability, and due diligence, while CEOs would be protected against the widespread impression that they exert excessive influence over directors. For such a plan to occur, it will take a forward-thinking board of directors and an open-minded and confident CEO to recognize that better information and analysis, along with a more informed debate, will benefit the company's customers, shareholders, and employees.