Small-Cap Governance's 'Aha!' Moment?

By Adam J. Epstein

Few who have seen it can forget the iconic scene in the 1987 movie *Wall Street* when Michael Douglas' character Gordon Gekko stands up, microphone in hand, at Teldar Paper's shareholder meeting and says: "The point is, ladies and gentlemen, that greed, for lack of a better word, is good. Greed is right, greed works." Could this stuff of cinematic legend also be the key to better small-cap corporate governance?

Those ensconced in the mid- and large-cap governance ecosystems often proclaim that the days of boards being predominantly comprised of friends of the CEO are in the rearview mirror. However, those who spend time in the vast majority of public company boardrooms—those of micro- and small-cap companies—know differently. But has governance at smaller public companies improved in the wake of Sarbanes-Oxley and Dodd-Frank? The short answer is: a bit.

Institutional investors know that, more often than not, the boardroom efficacy of any given small-cap company is a reflection of the CEO's personal valuation of corporate governance.

Institutional investors lament that many micro- and small-cap CEOs view corporate governance as an expensive, form-over-substance, time-consuming, necessary evil that adds little value.

Contrast that widespread perception with the fact that the largest institutional investors spend fortunes on analyzing corporate governance in their portfolio companies. Put differently, those who manage trillions of dollars believe that better governed companies will put more money in their clients' pockets, yet scores of micro- and small-cap CEOs appear to believe that corporate governance is a waste of time.

If this seems confounding, it is. How could this be the status quo?

Founder's syndrome. Many small public companies are inextricably linked to their founders. Those founders often feel that they themselves are uniquely suited to guide the company forward. (And sometimes they are right to feel that way.) In other words, visionaries require unimpeded views of the future, so all "non-visionaries" need to stay out of the line of sight.

Self-fulfilling prophecy. When CEOs intuitively feel like they benefit little from supervision, they install board members who will default to "oversight-lite." Corporate governance is thus reduced to a tautology.

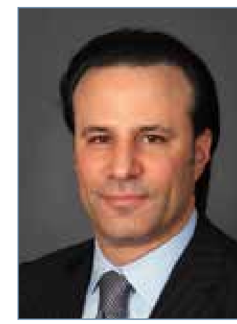
Regulations and activism. Entrepreneurs are oftentimes independently minded, and revel in upsetting the applecart. It's not surprising that they aren't keen on Congress, stock exchanges, or hedge funds trying to tell them how to run their businesses. The more that rigorous oversight is foisted upon small-cap CEOs, the more it is reviled.

Perhaps the path to more committed, fulsome small-cap corporate governance lies in the carrot, and not the stick. What if small-cap CEOs were to realize that public companies overseen by artfully composed, courageous, engaged, and truly objective boards tend to make more money? What if boards could be seen as a means of adding value instead of endangering the CEO's vision for the company?

I tested this "carrot" during a panel discussion where my audience was predominantly micro-cap CEOs and the advice went over with a resounding thud. Or so I thought.

Over the subsequent weeks, I received numerous phone calls from the CEOs who attended. One of them said he was chagrined to admit that he'd never once thought that more effective governance would put more money in his pocket. Another had a similar comment, and poignantly conceded that it's impossible to square his view with BlackRock's extensive analysis of portfolio company governance.

Maybe a little greed is what's required to change the paradigm once and for all; i.e., "If better governance is going to financially benefit me, the CEO, and my shareholders, then sign me up!" Probably not greed in the Gordon Gekko sense. Maybe more like Warren Buffett greed.



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