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After the Scandals: Changing Relationships in Corporate Governance

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Regulatory Policy Program

The Regulatory Policy Program at the Mossavar-Rahmani Center for Business and Government provides an environment in which to develop and test leading ideas on regulation and regulatory institutions. The Program's research aims to improve the global society and economy by understanding the impact of regulation and by creating better decisions about the design and implementation of regulatory strategies around the world. Additional information about the Regulatory Policy Program can be found at: http://www.ksg.harvard.edu/m-rcbg/rpp

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This report represents the authors' efforts to summarize the issues and amplify the themes that emerged during the roundtable dialogue. The perspectives and views expressed in this report do not necessarily reflect those of its authors, the Regulatory Policy Program, the Mossavar-Rahmani Center for Business and Government, the John F. Kennedy School of Government, Harvard University, Ernst & Young LLP, or any individual participant in the roundtable. The roundtable session was held on a not-for-attribution basis, so this report does not purport to attribute any specific statement or opinion to any participant. Furthermore, although this report synthesizes the roundtable dialogue, it should not be construed as representing a consensus statement or a shared set of ideas or recommendations.

Introduction

Corporations have had to confront important shifts in public scrutiny over the past several years, from highly publicized criminal trials to the implementation of new standards by the United States Congress, the Securities and Exchange Commission, the Public Company Accounting Oversight Board, and the nation's stock markets. Recent scandals, such as those involving Enron and WorldCom, show how corporate abuses can lead to the downfall of massive companies, with dire consequences for employees, shareholders, and society at large. Scandals such as these also raise questions about the overall integrity of the marketplace, sapping Wall Street of the confidence needed to encourage productive investment and fuel economic growth.

The prosecutions and regulations adopted in the wake of these scandals have aimed to change behavior among key actors who manage and oversee corporations, and thereby to restore integrity and confidence to capital markets. The passage of time since the prominent series of scandals first unfolded now makes salient the question of what practical difference these governmental reactions and reforms may have made. With retrospection, we now can begin to take stock of changes in key relationships in the corporate world, consider why some of these key relationships have changed, assess whether these changes were intended or unintended, and evaluate whether they have been positive and sufficient.

In this post-scandal era, some have claimed that previously cooperative relationships among CEOs, directors, shareholders, auditors, lawyers, and others have become much more adversarial. Are CEOs and boards increasingly at odds with each other, at least compared with their interactions in the past? Are outside auditors and lawyers less cooperative with management than before? Are certain institutional investors (such as pension funds or hedge funds) pressuring corporations more aggressively? If even one of these changes is indeed taking place, is it bringing healthy competition and sorely needed accountability? Or is it creating counterproductive conflicts, costs, and caution, interfering with the efficient management of corporations?

To address questions such as these, the Mossavar-Rahmani Center for Business and Government, through its Regulatory Policy Program, convened a roundtable dialogue on corporate governance in May 2006. The roundtable's explicit purpose was to explore the changing relationships among chief executive officers, boards of directors, audit and compensation committees, auditors, investor groups, and regulators in the wake of Enron, WorldCom, and the other corporate scandals, as well as the consequences of policy reforms resulting from the scandals. The roundtable involved a select group of about thirty leaders from the nation's regulatory, business, legal, investor, accounting, and academic communities.

This report summarizes the roundtable discussion. Given the diverse perspectives aired, the report does not purport to offer a definitive set of conclusions or recommendations, but rather it seeks to identify some of the most important changes that appear to have emerged after the scandals and to highlight key implications for future consideration by both business and government. The sections that follow address changes in relationships that have occurred inside the boardroom, with auditors and other gatekeepers, and with shareholders, in particular hedge funds and other institutional investors. The report also considers a salient aspect of corporate governance that has not changed very much: namely, executive compensation. Finally, the report outlines some of the key questions and challenges that lie ahead for public policy about corporate governance. Only by paying careful attention to the kinds of issues raised in this report can business leaders, policymakers, and academics work together to create better ways of preventing corporate abuses while still ensuring ample opportunity for productive private sector investment and entrepreneurship.

Changes in the Boardroom

The composition of corporate boards has changed noticeably in recent years. Increasingly, directors come from outside their companies. To be sure, the trend toward more independent directors on the boards of public companies began before the recent wave of scandals, but it has accelerated over the past five years. Such acceleration is no doubt due, in large part, to the promulgation of rules and listing standards requiring that boards (or certain of their committees) be composed primarily or entirely of independent directors.

Corporate boards also lately have fewer "serial directors"—individuals who sit on the boards of numerous public companies. Indeed, the degree to which board members continue to be "over-boarded" has become one basis on which corporate governance programs are rated. At the same time, the splitting of the roles of the CEO and the board chair appears to have increased as well. Even where these roles continue to be merged, the number of "lead directors" has risen.

The implication of these several trends seems clear: if only one or two directors on any board now come from management, and if there is pressure to reduce the number of boards on which an individual director sits, then the number of openings for independent directors must increase. Will there be a sufficient number of qualified individuals to fill this increased need? Although it is by no means evident that a shortage exists now, it seems likely that the future will see a greater number of directors coming from groups traditionally not as well represented in the boardroom—groups such as younger people, women, and minorities.

Whether the greater formal independence of board membership will translate to an increase in actual independence remains an open question. Individuals who satisfy the formal, legal criteria for "independence" still may be subject to great influence by the CEO. And even the possession of considerable subject-matter expertise by independent directors does not guarantee that they will stand up to management when needed.

One factor that may drive boards toward actually exercising greater independence is the fear of liability. It appears that directors are more afraid of their own potential legal liability than before. This increased anxiety no doubt derives from the well-publicized civil and criminal actions alleging corporate malfeasance—including some against directors. Indeed, at least a couple of high-profile proceedings have been settled on terms requiring directors personally to contribute to the settlement fund.

Although directors have increasingly become targets of law enforcement and civil litigants (particularly shareholders)—and although increased director concern about personal financial and reputational exposure is understandable—it does not follow that the substantive legal foundation for director liability has expanded materially. Enforcement actions continue to focus on directors who allegedly have been involved in fraud directly or have actively aided in the commission of fraud, not those who may have been insufficiently diligent. Because the business judgment rule remains a viable defense, directors will generally remain immune from liability—provided of course they are not involved in egregious conduct or conduct designed to advance their own personal self-interest.

Gatekeepers and the Corporation

Just as change has occurred inside the boardroom, it has also occurred in some relationships with gatekeepers and others external to the corporation. Key external relationships include those between boards (or CEOs) and auditors, law firms, and investment banks, each of which has seen various types of changes in recent years.

Changes in the auditor relationship have been the most noticeable of all these changes—a consequence of the combination of the demise of Arthur Andersen and the emphasis on auditing in policy reforms such as the Sarbanes-Oxley Act and its implementing regulations. Section 404 of that Act, for example, generally requires that outside accountants attest to management's assessment of the effectiveness of its internal controls and its internal financial reporting procedures. In the view of many, these new regulatory requirements appear to be having a noticeable effect on the cultures and internal control practices within corporations. Financial statements may now be more accurate and disclosures more reliable. Investor confidence in corporate financial reports may be increasing as a result.

These improvements have not been without cost. Some in business have complained about increases in auditing fees—apparently the result of the increased time spent by auditors on engagements. As both corporations and auditors adjust to new regulatory requirements and accounting standards, and as companies tighten controls based on audit recommendations, these costs may decline, or at least level off.

A potential longer-term consequence involves the complaint that some have expressed that outside auditors may be becoming too risk-averse. Any such trend cannot be blamed solely on Sarbanes-Oxley. Certainly the risk of civil or criminal litigation against accounting firms and their partners for violating pre-existing statutes—as in the criminal prosecution of Arthur Andersen that effectively doomed the firm—would have contributed to any tendency toward defensive accounting.

It is perhaps too early to tell, but we may see a similar issue arise in the relationship between corporations and their investment bankers. In one well-publicized case, the SEC initiated an enforcement action against Merrill Lynch and individuals in its investment banking group for their role in Enron's Nigerian barge deal. The SEC alleged that the respondents aided and abetted accounting fraud by Enron. Without admitting or denying the allegations, Merrill Lynch agreed to settle the claim and to pay $80 million in disgorgement, penalties, and interest. Several former Merrill Lynch investment bankers were subsequently convicted of conspiracy and fraud in a criminal proceeding arising from the same Nigerian barge engagement; their appeal is pending.

Criminal prosecutions and civil actions against investment bankers may well lead to concerns about the same kind of tensions that some have noted with accountants. As bankers become increasingly concerned about their corporate and personal exposure, they may become less willing to rely solely on their clients' disclosures and may insist on engaging in more detailed and far-ranging due diligence. This result could have an obvious effect on the level of investment banking fees.

Outside lawyers have probably seen fewer changes in their relationships with corporate clients than have their counterparts in accounting and investment banking, although the demand for

lawyers has undoubtedly increased as a result of new requirements imposed on corporations by Sarbanes-Oxley and other legal and regulatory developments. To be sure, Sarbanes-Oxley and its implementing regulations impose new obligations on attorneys appearing and practicing before the SEC to report certain material violations of law of which they become aware. But the SEC has deferred on a proposal to require lawyers to cease representing clients and to notify the SEC if they become aware of a material violation of law. This "noisy withdrawal" proposal, if adopted, would dramatically alter the relationship between lawyers and corporations. Although the SEC has a number of open investigations involving legal counsel, only a few cases alleging that lawyers or law firms contributed to corporate fraud have been brought. Such proceedings, as well as cases brought by private litigants (including a pending shareholder class action against outside counsel to Enron), could in the future affect the ways that lawyers relate to their corporate clients.

Shareholders and Their Influence

As owners and sources of capital, shareholders cannot be neglected in any account of post-scandal changes in corporate relationships. For many years, the role of shareholders in corporate governance has been largely peripheral. Large corporations, for example, have tended to restrict the power of shareholders to elect directors. Selection of directors is only one way that shareholders can influence decisions by boards of directors, but the current role given to shareholders illustrates their traditional lack of influence. Generally shareholders now may vote for candidates nominated by the board, or they may withhold their votes from all or fewer than all nominees. In many cases, withheld votes are not considered "nays." The result is that if just one share is cast in favor of the candidate and all other shares are withheld, the nominee will be elected. This effectively diminishes the power of shareholders—individually or collectively—to contest board nominees. Power is further reduced in companies that still have a classified or otherwise staggered board, as it takes far longer for shareholders to change the composition of the board effectively when only a few directors come up for election in any given year.

Various proposals seeking to increase shareholder influence in electing directors have been advanced over the past several years. In mid-2003, the SEC's Division of Corporation Finance issued a staff report on shareholder access that recommended the development of rule proposals for director selection. The SEC then proposed that, in certain circumstances, companies be required to include in proxy materials information about board candidates nominated by long-term shareholders. The proposal generated considerable opposition and was never adopted. However, pressure to move to majority voting for directors clearly has been mounting steadily in recent years, with hundreds of shareholder proposals on the subject introduced in recent proxy seasons. Although many of these proposals have been rejected, there have been some notable cases where they have been approved. Attempts to pass proposals increasing shareholder influence over the selection of directors are likely to continue in the future.

The role of institutional investors will also remain important in the future, as institutions continue to own a majority of public shares. Until recently, institutional investors have been frequently viewed as monolithic, but this view appears to be changing. Pension funds represent employees in either the public or private sectors, and their interests can vary across these sectors. Similarly, mutual funds that are affiliated with a 401(k) administrator or a bank are likely to approach an issuer differently from mutual funds that do not have such relationships (especially if the issuer is already a client of the affiliate). Affiliations aside, the interests of pension funds, mutual funds, and other institutional holders are not always aligned, making their role in corporate governance more complex than ever.

The complexities of shareholder influence become still more pronounced with the advent of hedge funds and other nontraditional funds that have grown more activist. Proxy contests tend to be unrealistic for retail investors, who have insufficient holdings and assets; such contests are also not worthwhile for many pension funds and mutual funds since the securities of any single issuer usually represent only a small percentage of a fund's overall portfolio. Hedge funds, on the other hand, often have large stakes in fewer companies; they also have considerable financial assets at their disposal, and they have the analytic skills and resources with which to wage a proxy contest. In fact, over the past year or so, several hedge funds have used their portfolios aggressively to fight, not only for changes in the composition of the board, but also for decisions involving mergers, corporate break-ups, and other corporate events.

CEOs and Compensation Committees

Executive compensation is perhaps the most significant issue that has shown little change. Despite continued—indeed, mounting —public criticism that executive compensation has been out of line and that the typical board structure for setting executive pay is seldom arm's length and effective, few systemic changes appear to have occurred.

Of course, part of the difficulty of grappling with executive compensation is that there is no generally accepted standard for determining what compensation level is appropriate. Should compensation be measured on the basis of the firm's revenue, its profits, or its share price? Should it be based on the company's performance in isolation or in comparison with that of its peers? If based on a comparison, are peers to be determined on the basis of some aspect of size, or industry, or something else? Without agreement on a way to determine appropriate compensation, shareholders and the public generally will have a hard time judging excessive compensation by anything other than the standard that Supreme Court Justice Potter Stewart invoked in an entirely different context: "I know it when I see it."

So far the only proposed policy change in this area would simply enable current and potential shareholders to "see it" better. In January 2006, the SEC issued a proposed revision of disclosure requirements pertaining to compensation for executives and directors, as well as related party transactions and share-ownership of officers and directors. The SEC's proposal has generated wide comment, but a final rule has not yet been adopted. If the SEC does eventually adopt a disclosure requirement, it remains to be seen how executive compensation will change. Some suggest that when CEOs learn of their counterparts' compensation packages, they will be more likely to demand something comparable from their own boards. A "race to the top" in the size of packages would only exacerbate investor concerns about excessive compensation. Any resulting increases in compensation will be all the more troubling if they are based on inappropriate comparisons—that is, comparisons made when boards ignore important distinctions among companies that might justify different treatment.

The theory underlying the disclosure approach is that it will enable shareholders to "vote with their feet" and help the market correct for excessive compensation. This will require that boards actually heed the threat of punishment to share price. Yet on various occasions in recent years, boards have approved lucrative compensation arrangements even though shares have underperformed the market. Some boards have granted gratuitous "farewell payments" even when a CEO has been forced to resign. Still other boards have not demanded reimbursement when financial results—on which all or some of the compensation was based—were restated downward. Such instances suggest that the existence of gross anomalies in executive compensation may not be cured by disclosure alone.

The responsibility for addressing compensation issues ultimately rests with the board and especially its compensation committee. In terms of their expertise and effectiveness, compensation committees seem to be today where audit committees were ten years ago. Regulation and accounting standards may partly explain the greater relative effectiveness of today's audit committees. These committees also differ in terms of how they align with the interests of the CEO. In general, audit committees and CEOs share a common interest, as neither is well served if financial reporting is inaccurate. With compensation, however, the unity dissolves and the CEO and the compensation committee (and the board) may be more accurately viewed as in tension with one another.

To be sure, this tension may be more theoretical than real. Even though listing standards now require independent members to sit on compensation committees, the existence of formal, legal independence does not necessarily equate to independence in fact, as noted earlier. In the case of compensation committees, committee members who are CEOs of unrelated companies may be formally independent and yet have an obvious, common interest in lucrative packages, especially if the disclosure of these packages later helps them negotiate their own compensation arrangements with their own boards.

Even if the members of compensation committees are not CEOs, they may still lack the expertise needed to make good long-term decisions about compensation. Audit committees are now effectively required to have at least one member who is a "financial expert" (as defined by the SEC). There is no comparable requirement for the compensation committee, and there have been situations where the compensation committee may not have fully understood the arrangements it approved for the CEO. Yet even when the committee does understand the technical aspects of a compensation package, it may not understand how particular incentives actually will motivate management behavior. Perhaps the clearest example is the stock option itself. Although intended to align the CEO's interests with those of the other shareholders, the stock option may have made some CEOs overly fixated on short-term results or prone to accept accounting gimmicks.

It is far from clear whether compensation consultants are the answer. Although the law now specifies detailed criteria for auditor independence, nothing comparable exists for compensation consultants. When such a consultant also works for the company on other matters (or works for other companies whose officers or directors are members of the compensation committee), questions will arise about perceived or actual conflicts of interest.

Future Challenges for Public Policy

All of the aspects of corporate governance addressed in this report—boards, gatekeepers, shareholders, and executive compensation—raise important public policy issues. Notwithstanding all of the changes that have already occurred, a primary challenge remains for both business and government: to seek out an appropriate balance in the relationships that make up corporate governance. For those relationships that have undergone significant changes in recent years, an initial issue is whether these changes have occurred for the better.

Many believe that the spate of scandals in the early part of the millennium demonstrated that the pendulum of corporate influence had swung too far in favor of the CEO. The changes we have described—increased board independence, accountability of gatekeepers, and shareholder assertiveness—represent for them a better balance among the various corporate governance relationships. Of course, some also believe that these changes, although helpful, have not gone far enough and that still greater shareholder voice, board control, and gatekeeper vigilance is needed. Others worry that even valid attempts to counterbalance CEO control can go too far, and fear the risk aversion and adversarialism that may come with greater shareholder, board, or gatekeeper involvement.

Assuming that some further changes are still needed—whether they are modifications that undo changes that have already occurred, that go further along the lines of current changes, or that address issues such as executive compensation that have so far gone largely unchanged—the next issue will be how to bring those additional changes about. Some advocates of change will undoubtedly call for further governmental action, but government will not always be the best answer. Sometimes it would be better for government to step aside and allow changes to evolve through shifts in business practice norms or through market pressures. It is instructive to see various institutional investors in recent years insisting that companies adopt governance reforms. Perhaps these market pressures will lead to more optimal arrangements than anything that government itself could prescribe.

Deciding how to respond to corporate governance after the scandals will benefit from careful inquiry into how these scandals arose in the first place. Some will undoubtedly question whether Sarbanes-Oxley or other recent policy reforms could have prevented abuses such as those in Enron and WorldCom. Some will argue that such abuses derive from a decline in business values, or from the fact that too many business leaders have forgotten what it means to be a fiduciary. They might even argue that recent abuses stem from something more deeply embedded in contemporary culture—a selfishness that afflicts many institutions in society, not only business. Research on the causes of corporate governance failures is therefore imperative. If corporate scandals stem from the same kind of underlying cultural problems that some insist afflict politics, sports, and even religion, then the core challenge for public policy will be to find ways to engender nothing less than a fundamental cultural shift.

Whatever direction public policy may head in the future, decision-makers will also need to be mindful of the key choices and tradeoffs found throughout different areas of corporate law. For example, just as they have already, corporate governance reforms will raise a tension between, on the one hand, the accountability that can come from reinvigorated checks and balances and, on the other hand, the potential for gridlock and adversarialism. Similar tensions will arise in how gatekeepers perform their roles, whether as partners or as police. Tensions exist between long-term and short-term focus, between state and national policy solutions, and between governmental control and market responsiveness. These tensions have a direct bearing on the continuing vitality of the U.S. capital markets. Indeed, there is already concern that the costs associated with post-scandal regulations have prompted some public companies to delist their securities, and other nonpublic companies to remain private, thus taking advantage, in certain cases, of greater funding opportunities provided by "private equity" funds. Some would even caution that if the regulatory costs and legal risks facing businesses grossly outweigh any benefits in terms of improved market integrity, the United States could become a less attractive place for both domestic and foreign companies to raise capital.

On these and many other dimensions of corporate governance reform, the quest for decision-makers will seldom be to find which side is better—adversarialism or cooperation, for example—but rather to discover the optimal balance, over time and in different circumstances, between the polar extremes.

APPENDIX A

Roundtable Agenda

After the Scandals: Governing Relationships

MAY 9, 2006

Welcome

David T. Ellwood, Dean and Scott M. Black Professor of Political Economy, John F. Kennedy School of Government

Keynote Address

The Honorable Roel C. Campos, Commissioner, Securities and Exchange Commission

Session I: Changes

OPENING COMMENTATOR

Jay W. Lorsch, Louis E. Kirstein Professor of Human Relations, Harvard Business School

MODERATOR

Cary Coglianese, Chair, Regulatory Policy Program, John F. Kennedy School of Government

(Cont'd.)

Session II: Implications

OPENING COMMENTATOR

Richard C. Breeden, Chairman, Richard C. Breeden & Co.; Chairman, Securities and Exchange Commission, 1989–1993

Moderator

Thomas J. Healey, Senior Fellow and Adjunct Lecturer, John F. Kennedy School of Government

Synthesis

Robert C. Pozen, Chairman, MFS Management

APPENDIX B

Keynote Address

The Honorable Roel C. Campos
Commissioner, U.S. Securities and Exchange Commission

Good afternoon everyone, and thank you, Dean Ellwood for that kind introduction. I also wish to thank the Kennedy School of Government and Professor Cary Coglianese and Senior Fellow Michael L. Michael for the invitation to be here. It's absolutely great to be back here at Harvard and to meet with such an impressive and diverse group. Obviously, we at the Commission are extremely interested in the subject of corporate governance and the relationships among company management, the board of directors, and shareholders, and so I know I'll find today's discussion interesting.

Before I start, I must issue the standard SEC disclaimer that this speech expresses my personal views and does not necessarily reflect those of the Commission, other commissioners, or members of the SEC staff. With that said, let's move on to business.

I thought that I would focus today on a few topics that concern the relationships among the various constituents of a company, although, given the shortness of time, I can't go into great depth in many of these areas. These topics are (1) the new corporate relationships imposed or fostered by the Sarbanes-Oxley Act of 2002 (SOX); (2) the new shareholder activism; (3) shareholder access to company proxy materials for the purpose of nominating director candidates; and (4) executive compensation disclosure, a topic that includes what the

Commission is doing on this front and what shareholders are doing directly.

Of course, I understand that there will be time for questions, and at that point perhaps we can discuss items such as our hedge fund registration rules, internal controls under Section 404 of the Sarbanes-Oxley Act, or any other topic that you may be interested in.

Before I jump into these topics, let me tell you a story I recently heard: A man is in a hospital, awaiting a heart transplant. Before the surgery, he speaks to his doctor, who informs him that he actually has two choices. The doctor says, "Well, you have a couple of different hearts to select from here, although I think the best choice is pretty clear. The first option is a heart that belonged to a 22-year-old competitive swimmer. Needless to say, the swimmer was in great shape, but tragically, she died young of complications that were completely unrelated to her heart. The second option is a heart that belonged to a 55-year-old attorney at the Securities and Exchange Commission. He was somewhat overweight, didn't exercise much, and smoked all of his life. As I said, the choice seems clear to me, but it's your call." The patient thought for a moment and said, "Thanks for giving me the option. I think I'll take the heart that belonged to the SEC attorney." After getting over her initial shock, the doctor responded, "Why on earth would you pick that heart? It's been through a lifetime of hard living." To which the patient responded, "Well, I've been in the securities business my entire life. Everybody knows that SEC attorneys never use their hearts."

New Relationships in Light of the Sarbanes-Oxley Act of 2002

The Independent Audit Committee

Probably the most significant change imposed by SOX relating to the board/management structure was found in Section 301, which amended the Exchange Act and explicitly mandated that the audit committee—which must be comprised solely of independent directors—be in charge of the relationship with the outside auditor.

Section 301 removed the prior problematic relationship in which the outside auditor was hired by management and the CFO, which also meant that the auditor essentially worked for and reported to management, despite its legal duties to the board and the corporate entity. In addition, Section 301 provided that the audit committee must have the authority to hire independent counsel or other advisers, separate from the auditors, and it required the audit committee to have a grievance procedure in place to resolve any concerns about questionable accounting or auditing matters. Further, Section 407 of SOX requires disclosure regarding whether the audit committee has at least one member who qualifies as an audit committee financial expert. Finally, the audit committee is also responsible for assessing the independence of the auditor and for ensuring that the auditor does not perform work for the company that jeopardizes that independence.

In short, the audit committee, and therefore the overall board, is now required to maintain the integrity of the audit process, which of course ultimately leads to the preparation of the financial statements upon which investors rely. It is hard to overstate the significance of the audit committee process under Section 301 and the other sections of the Act. SOX has significantly and permanently changed the dynamics of the relationship between the board (especially the audit committee) and management, and it has resolved many potential conflicts with management. To my knowledge, based on anecdotal evidence, this relationship seems to be working well.

Majority Board Independence, Independent Compensation, and Nominating Committees

A second area of change that has occurred in the wake of the Sarbanes-Oxley Act is the increased role of independent directors generally. In this regard, SOX dealt only with the independence of the directors on the audit committee. However, in response to pressure from the Commission and in light of the changed regulatory climate, the self-regulatory organizations (NYSE and NASDAQ) produced listing standards that ultimately required (1) that an issuer have a board comprised of a majority of independent directors, and (2) that two vital committees—the nominating committee and the compensation committee—be comprised solely of independent directors (with limited exceptions). The SROs defined "independent" primarily by listing specific instances in which directors would not be considered independent, and these are principally related to whether directors (or certain family members) had received compensation through a financial relationship with the issuer. Of course, the goal of having independent directors is to allow directors to function essentially free of financial conflicts and overdependence on management.

What is clear, however, is that meeting the definition of "independent" does not mean that directors will not be beholden to management in some way. Obviously, a lifelong friend of the CEO could meet the technical definition of "independent." Public company boards continue, it seems to me, to be a very exclusive club to which directors are essentially invited to join. It is basic human nature to be grateful for the invitation, and the desire not to be viewed as a troublemaker is quite strong. Certainly, management—especially the CEO—continues to have a large role in selecting or at least approving board members. Separately, it must be said that, to date, compensation committees have not been successful in stopping the runaway compensation paid to CEOs. More on this later.

The relationship between directors and shareholders is increasingly important. It used to be said that directors met and communicated with all parties except shareholders. Now, however, SEC rules have encouraged better communication between directors and shareholders, including specifying how shareholders can present nominees to the nominating committee. Some companies have started using websites and e-mail and/or have an on-call system to answer questions. Other good practices include meeting in executive sessions without management and having an independent chairman of the board or lead outside director. The challenge to both directors and management is how to have a relationship of trust and support without being adversarial, at the same time ensuring that directors raise tough questions with management and critically assess the worthiness of business plans. For example, I do not believe, as many have argued, that the new relationships and dynamics will stifle appropriate business risk taking and creativity.

Director and Officer Liability

A third effect of the Sarbanes-Oxley Act, at least with respect to the relationships among constituents at public companies, is that it created a sense of greater liability for directors and certainly for management. In particular, the greater civil and criminal penalties have certainly been noticed by the public. With respect to directors, however, there has really been no direct imposition, either by statute or case law, of additional liability. The recent Disney case, in spite of stinging criticism by the Delaware Chancellor, essentially held that it was within the business judgment of Disney's directors to determine not to fire Ovitz for cause and to pay him over one hundred million dollars as severance.

Still, the environment feels more dangerous, and directors certainly are concerned about being dragged into lawsuits and spending their valuable time and resources to defend themselves, even if they are ultimately found not to be culpable. The SEC has not brought any cases after the Sarbanes-Oxley Act against directors or issued any guidance that might alter the business judgment rule. In other words, a decision by the board that is not otherwise against the law does not have to be the best or even a good one, so long as it is based on promoting the best interests of the corporation and complies with the states' formulation of the business judgment rule. Many commenters also favor legislation to curb, in some way, plaintiffs' lawsuits against public companies and their officers and directors. That said, my checking indicates that directors' and officers' liability insurance rates seem to have stabilized.

Relationship with the SEC and Other Regulators

A defining moment for a board and issuer is when the SEC or another law enforcement or regulatory agency commences an investigation. The relationship with authorities will be vital. Self-reporting (if a problem is first discovered by the company), cooperation, independent investigation by the board, waiver of the attorney-client privilege, deciding whether or not to provide legal support to officers and employees, termination of culpable officers and employees, and communication to the shareholder base are all areas of huge consequence to the final resolution of the problem.

Shareholder Activism and the Response of Directors

The subject of shareholder activism (and, in particular, hedge fund activism) and what it means with respect to the management of companies has become a topic for the water cooler. It's difficult to go a week without reading about efforts by hedge funds to change the management, operations, or business plans of a company in which a hedge fund owns a stake.

Generally

In some respects, shareholder activism is a new phenomenon, for it has been only recently that hedge funds have achieved the size and the focus to affect significantly the management of companies. In other respects, however, hedge-fund activism is merely evolutionary, reflecting just another—although perhaps more widespread—variant on shareholder activism that first became prevalent in the 1980s when corporate raiders were all the rage.

The debate over the benefits of shareholder activism—be it from corporate raiders, hedge funds, pension or mutual funds, or even law school professors (such as your colleagues at the Law School) who submit proxy proposals to companies—generally focuses in large part on one's beliefs about the principal-agent relationship that defines how corporations are run. (I will put to the side an extreme view that challenges the shareholder ownership model by claiming that shareholders are simply free riders who can walk away by selling their shares and that it is only management that creates value.)

On one side of the debate, the shareholder activists argue that it is the shareholders who own the company, and therefore they should have a more active role in running it. Those on this side of the debate generally don't advocate that shareholders get involved in the ordinary business operations of a company, but they do contend that shareholders should have a significant voice in some of the more important or high-profile decisions, such as executive pay, acquisitions, sales of significant assets, and the payment of dividends. The shareholder activists often point to, among other things, numerous examples of directors and management enriching themselves at the expense of the true owners of the company. They maintain that excessive executive compensation is essentially raiding the corporate till.

On the other side of the debate, many business groups and others argue that the director-centric view of corporations has been ingrained in corporation law for a century and has proven to work extremely well. Those on this side of the debate point out that directors have a legal duty to act in the best interests of shareholders and to oversee the business and affairs of corporations, and that they are more informed and better able to look after the long-term interests of a corporation than are the shareholders. Directors, it is argued, can better deal with all of the corporate constituencies—creditors, employees, and the government, as well as shareholders. Indeed, this group argues that shareholders are often quite heterogeneous, with some shareholders focused on short-term gain and others focused on long-term performance.

Of course, this is not an "either-or" proposition. One can generally take the view that a more director-centric version of corporate governance should prevail, while still admitting that certain measures designed to give shareholders more power can be positive. On the other hand, those who are more shareholder-centric in nature will often still admit that, generally speaking, it is the directors who are best tasked with running the corporation.

In recent years, however, it does appear that the pendulum has been swinging to the side of increased shareholder activism, which is likely due in part to the high-profile scandals of a few years back and also to the ascendance of hedge funds. The Commission has proposed and adopted a number of rules seeking to give shareholders greater access, which I personally think is a generally good thing (and which I'll discuss later in my remarks).

But beyond one's beliefs about the theory of shareholder activism, corporate boards must often deal with this in reality. This raises the question of whether a board, when faced with a direct challenge by shareholders, should view such a challenge with hostility or with open arms. Obviously, this is often a very

case-specific inquiry that cannot be answered with generalities and will of course depend on the context in which the company and the hedge fund interact. But let me give you my thoughts on how directors might respond to increased activism.

How Should Directors React?

Obviously, a director's response to shareholder activism will vary on a case-by-case basis. If a director believes that the company has a cogent long-term strategy, it is certainly his or her right to react negatively to what he or she believes is merely an effort to pump up the stock in the short run.

But it seems prudent for directors to have an open mind when confronted by large shareholders. After all, they do own part of the company. At a minimum, the activist hedge fund may be offering "free consulting." (Just kidding.) However, being open to negotiation and, at a minimum, listening to what the shareholders have to say makes sense. Often hedge funds have pushed companies to think about the nature of the business and to consider whether the current course is the proper course. It may be that a short-term reform, despite an immediate disruption, will prove beneficial in the long run. Many of the large hedge funds have done extensive research, albeit perhaps in the interest of making a tidy return, and therefore might be mostly correct in their recommendations.

To use one example, I see some positives in the fact that General Motors acquiesced to pressure from Kirk Kerkorian and Tracinda Corporation by naming Jerry York, a Tracinda adviser, to the board. On the one hand, I thought it spoke well of GM that it named a frequent critic to its board, which I think evidences its desire to seek the experience and opinions of someone who is truly independent from management. I also thought it spoke well of Tracinda, which publicly stated that York agreed not to share any confidential information with Kerkorian, thereby removing a potentially thorny issue from the mix. Obviously, it's far too early to expect to see definitive results, but again, I took comfort in the fact that GM's board was willing to make real changes, such as halving its dividend and cutting its executive pay by 30 percent. Moreover, published reports have claimed that York has become a key figure in the boardroom and that outside directors are increasingly looking to him to set the tone and agenda. If this is the case, perhaps York can provide another point of view as GM seeks to rebound from recent troubles.

In the end, I can't really say whether hedge funds or other shareholder activists are enemies or friends of directors and management. It all depends on the circumstance. It is a current fact that more and more hedge funds will be acting like private equity by taking large equity positions in companies and seeking to influence board and corporate behavior. Governance as an investment style is a popular flavor with institutional investors. Whether these funds will be viewed as corporate raiders seeking short-term profits or whether they will employ long-term value strategies remains to be seen. One may well see strange bedfellows in institutional investors aligning with governance-oriented hedge funds.

Shareholder Access

Now that I've talked more generally about shareholder activism, let me turn to a more specific part of shareholder activism. By that, I mean the issue of direct shareholder access to a company's board of directors and management.

The Commission's Shareholder Access Proposal

In particular, I want to refresh your recollection about a rule that we proposed two-and-a-half years ago regarding shareholder director nominations. Although this rule never progressed past the proposing stage, I still think it remains extremely relevant to the ongoing debate about corporate governance. Indeed, I think

the topic that it addresses—the ability of shareholders to nominate a candidate for director in certain instances—is an absolutely critical component to enhancing shareholders' ability to influence the affairs of a corporation.

Today, as most of you know, it is very difficult for shareholders to have any meaningful choice with respect to the election of directors. In particular, I'm referring to the fact that unless a shareholder mounts a full-blown proxy fight—which is very expensive and time consuming—shareholders do not have a real option of voting for a director other than one supported by management. Further, in the United States, unlike in the United Kingdom and other jurisdictions around the world, directors are elected by a plurality vote, which means that those directors receiving the most votes are elected to the board, even if those directors do not receive a majority of the votes cast. The only choices are to "vote for" a director or to "withhold" one's vote for a director, and a director will still be elected even if the votes "withheld" exceed the votes "for" a director candidate. Consequently, as a result of the difficulty of nominating alternative candidates for director, coupled with plurality voting, it is—as many have noted—very difficult to remove or replace any of the directors appearing on management's slate.

I may be the only one on the Commission who still feels this way, but I continue to be supportive of the proposals that we introduced in late 2003 that would have, under certain circumstances, required companies to include in their proxy materials a shareholder nominee for election as director. Had they been adopted, these rules would have created a mechanism for a nominee of long-term shareholders with significant holdings to be included in company proxy materials where there are indications that shareholders need such access to further an effective proxy process.

Part of what made this proposal so important in my opinion is that what it proposed to do was very different from that of many of the rules that we at the Commission have recently adopted in the wake of the corporate scandals of a few years ago and after the enactment of the Sarbanes-Oxley Act. Specifically, most of our other recent rules have dealt with our efforts to improve and enhance corporate disclosure. Our proposed rule regarding shareholder director nominations, however, was intended to do something quite different than merely improve disclosure: it was designed to empower shareholders to have a direct say in who is nominated to the board. To be sure, our disclosure-based rules also empower shareholders, but at the end of the day, if a shareholder, armed with all of this new disclosure, doesn't like what he or she sees, the only real alternative is to sell his or her stock in the company. Obviously, this is an unsatisfying choice for investors who believe in a company's products or services, but are less than enamored with current management or directors. Moreover, if you're an adviser to an index fund, the option of selling the fund's holdings in an indexed company is not even present.

This, of course, is one of the reasons why I'm still in favor of adopting a rule that would provide shareholders with a limited ability to nominate their own candidates for director, instead of having to settle for merely voting "for" or "withholding" votes for management's candidates. In this respect, our proposed rule was not merely incremental, like many of our recent disclosure-related rules, but would actually give shareholders an ability to influence director elections in a manner not now present.

Unfortunately, in my view, this rule has not been adopted, and I can't say that I'm very optimistic that it will be resurrected any time soon. That said, there have been a few interesting developments with respect to shareholder director nominations that bear mentioning.

Majority Voting Proposals

There is a relatively new movement afoot to elect directors to corporate boards by means of a majority vote. By this, I'm referring to the fact that, recently, a number of companies have adopted policies that require a director who receives more votes "withheld" than "yes" votes to submit his or her resignation to the company's nominating committee. The nominating committee will then consider the tendered resignation and will recommend to the board whether to accept or reject it.

Although the Commission itself is not responsible for the adoption of these policies, I should note that many companies have adopted them at the behest of shareholders, who have submitted proxy proposals in this regard. Of course, many companies have sought to exclude these proposals—much as they have sought to exclude shareholder director nomination proposals—but if properly phrased, the Division of Corporation Finance has generally not allowed them to be excluded. Indeed, one version of such a shareholder proposal takes the form of a binding shareholder resolution that would amend the bylaws to provide that the "directors shall be elected annually by written ballot and by the vote of the majority of the shares voted at a meeting at which a quorum is present . . . ."

I take these developments—both the voluntary "majority voting" guidelines adopted by companies and the binding bylaw amendments requested by shareholders—as indicating that management in some cases is listening and making enlightened decisions. Although these new policies still do not permit shareholders affirmatively to nominate a candidate for election to the board, they do allow shareholders to, in effect, vote off board members without having to engage in a full-blown proxy contest. Critics, of course, argue that amending bylaws in this respect (or making it more difficult to have staggered boards or poison pills) deprives the board of its proper role. That said, these proposals are just in their infancy, and it remains to be seen how effective they are. But I view them as a positive step in favor of shareholder democracy.

Executive Compensation

Let me move on now to probably the hottest topic that people are discussing nowadays. By that, I mean executive compensation. By now, the specific stories about excessive CEO pay have made the rounds in virtually every major newspaper in the United States, and I don't think I need to bore you with reciting the gory details. Indeed, many argue that payment for performance has been replaced with payment for pulse. Even the *Wall Street Journal* has published at least one article commenting negatively on excessive executive pay.

Now, a few moments ago I was trumpeting the benefits of our proposed shareholder access rule on the grounds that it did something more than require disclosure. However, it is certainly not my intent to disparage the incredibly positive effects that clear, extensive, and precise disclosure can provide.

Nowhere is this more the case than in the area of executive compensation. I think it is fair to say that, now, many of the decisions surrounding executive pay in the public companies in the United States have been made in very dark corners, difficult to discern and understand fully. Further, there is little question that it is extremely difficult to figure out from the current filings and disclosure what executives really earn. It can be extremely arduous to dig through all of a company's disclosures to discover, for example, what type of deferred compensation, change in control payments, retirement arrangements, or other perquisites have been negotiated.

Moreover, it is troublesome that such pay arrangements in many cases may not have been known to shareholders, and in some cases, may not have even been understood by directors.

Further, even when directors are fully informed and knowledgeable about executive compensation, there will always be pressure on compensation committee members to be a part of the club that rewards CEOs with excessive pay. I call this the "real estate appraisal" issue. In determining salaries, compensation consultants present the committee with figures showing average pay, and there will always be pressure on committee members to give their guy what the other guys get, or even slightly more. This is especially true if you have an aggressive CEO who gathers his own compensation data and asks, "why am I being treated differently from my peers?" In addition, many compensation committee members are CEOs or former CEOs themselves, so they're all part of the same club. As a matter of logic, even if a compensation committee thinks it's being conservative by compensating their CEO at the 50th percentile, this has the effect of driving up CEO salaries. Everyone can't be average.

In any event, I thought I would split my discussion of executive compensation into two parts. First, I'll discuss what the Commission is doing on this front, and second, I'll discuss what shareholders are doing. I think the latter topic is especially appropriate in light of the topic of today's dialogue.

What the Commission Is Doing

Simply put, our comprehensive executive compensation proposal is designed to set forth a revised disclosure regime for executive compensation. Although the proposals are extensive, a number of provisions are worth highlighting. First, the new rules would require that stock options and stock grants be valued in dollar amounts, presumably with the method that is used in expensing the option and stock grants for purposes of a company's financial statements. Second, the revised compensation tables provide for the computation of a total amount of compensation in the summary table of the executive's compensation—one figure that puts all of these compensation elements together. Of course, there will be some elements such as retirement that would principally be in narrative form, but the rules would require that examples be given as to what the executive would earn if normal conditions occur.

It is my hope that our proposals will provide investors with a tool that will enable them to understand the total compensation paid to the company's CEO, CFO, and other executive officers, and consequently to assess whether those executives, through compensation arrangements approved by directors, have earned their payments through performance. While, as I mentioned earlier, it is difficult for shareholders formally to oust directors who shareholders believe might not be capable of running their company, I still believe that public pressure, withhold-vote campaigns, and behind-the-scene discussions with management can be used by investors to bring about change in compensation.

Of course, the executive compensation story is not quite finished. As you know, we have not yet voted on the final executive compensation rules, and the comment period has been closed for less than a month. Not surprisingly, we have received literally thousands of letters on our proposed rules, and I know that our staff is currently sifting through them. It is my hope—as it is in every case in which we publish rules for comment—that we can use the comment process to improve upon our proposals. Let me touch on a couple of the comments that I found most interesting (although this is certainly not an exhaustive list):

- **Advisory Vote by Shareholders.** A number of commenters have suggested that we require companies to put the compensation report to an advisory shareholder vote, or that we seek an amendment of exchange-listing requirements to require such advisory votes. Alternatively, commenters have recommended that we

codify a no-action position of the SEC staff that has allowed shareholders to include in proxies non-binding resolutions that ask for an advisory shareholder vote on the compensation report. As an aside, I'll also note that Congressman Barney Frank has introduced a bill that would, among other things, require shareholder approval of compensation plans.

These are definitely intriguing suggestions, and, if adopted, no doubt would provide shareholders the clearest and most direct voice in executive remuneration. Apparently, the United Kingdom and Australia have an advisory vote requirement on the compensation report, and there appears to be some evidence that this may have some effect in curbing excessive executive pay. For example, one study in the United Kingdom found that executive pay is declining, and another article noted that the typical British CEO makes only a little more than half of what the typical U.S. CEO makes. In any event, having the shareholders cast an advisory vote on this subject would very likely improve transparency in this area, and for this reason alone, I think it is a topic worthy of additional discussion. Of course, requiring shareholder votes, even advisory ones, is not something that the Commission has done frequently, and so I think that we'll need to look carefully at our powers in this regard.

- **Disclosure of Performance Targets.** Another topic that comment letters touched upon is the fact that the proposal does not require the disclosure of specific quantitative or qualitative performance-related factors considered by the compensation committee or by the board in determining executive compensation.

Apparently, the argument for not including such a requirement would be to avoid forcing companies to disclose confidential commercial or business information that would have an adverse effect on the company. This is certainly understandable. On the other hand, without disclosure of these performance-related factors, it becomes difficult for shareholders to determine whether the targets are appropriate and whether executives actually have met the targets. Perhaps a middle alternative would be to require disclosure after the fact: that is, maybe it would be effective and appropriate to require companies to disclose the particular quantitative or qualitative performance-related factors after the time period for which the factors apply. Some commenters take the position that this would make the executive compensation process more transparent, yet alleviate concerns about disclosure of confidential information. However, companies might still be concerned that disclosure of specific targets even after the fact raises confidentiality issues that might ultimately harm the company. In any event, given the comment letters on the subject, this is an issue that we at the Commission should consider, and I intend to approach it with an open mind.

I could continue and recite at great length some of the insightful comments that have been submitted to us, but if I were to do so, I would surely eat up the time that has been set aside for questions. Rest assured that our staff is carefully reviewing the comment letters right now, and all of us on the Commission will pay very close attention to the public's suggestions on this topic.

What Shareholders Are Doing

Now that I've mentioned what the Commission is doing with respect to executive compensation, I thought I would also discuss what directors and shareholders can do (and indeed, are doing) about what they might perceive about excessive pay levels, given that the focus of this conference is on relationships among the various corporate constituencies. Earlier, I observed that the advent of independent compensation committees and the threat of litigation have not seemed to have curbed rising executive pay. So, where does that leave us? The answer, I think, is aggressive shareholder action, perhaps coupled with favorable rules and determinations from the Commission and our staff.

The most basic level of shareholder action is simply the standard pressure that shareholders, especially large shareholders, can place on a company via letter writing campaigns and effective use of the media. Often this type of shareholder campaign is stimulated by reports of excessive compensation or general criticism of corporate governance practices by entities that rate such practices, such as Institutional Shareholder Services. This tactic can sometimes be effective, as companies have a strong public relations incentive to take steps to maximize the corporate governance ratings.

At perhaps a second level of activism, there are shareholder campaigns to withhold votes from directors whom they believe do not exercise proper oversight over compensation practices. An example of this is UnitedHealth Group, which has been under fire recently for alleged improprieties potentially with respect to backdating option grants to top executives. At UnitedHealth's recent annual meeting, the shareholders (including CalPERS) showed their displeasure by withholding more than 28 percent of their votes for two compensation committee members. UnitedHealth's CEO has now apparently recommended that the board discontinue or suspend stock awards for certain senior executives.

Yet another level of activism involves submitting shareholder proposals seeking to require shareholder votes on various executive compensation matters. These proposals can take the form of non-binding requests that urge the board to limit or alter certain aspects of executive compensation, or they can be binding proposals that amend a company's bylaws to require shareholder ratification of certain executive compensation arrangements. An example of this is the efforts of Verizon retirees to force Verizon to limit executive compensation and to give shareholders a say in such compensation. In 2003, the retirees took the non-binding route and won 59 percent of the shareowner vote with their proposal to limit executive compensation packages and golden parachutes. In 2004, the retirees went the binding route by submitting a proposal that sought to amend the company's bylaws to require shareholder ratification of executive severance agreements in excess of 2.99 times the executive's base salary plus bonus.

Another variant on this heightened level of activism might involve a combination of the above tactics. For example, shareholders might propose a binding bylaw amendment to require shareholder ratification of certain executive pay arrangements, as well as another binding bylaw amendment to require that directors be elected by a majority of the shares voted at a meeting. This would allow shareholders to have a perhaps unprecedented say in executive compensation matters, as well a heightened ability to remove directors who aren't responsive to shareholder concerns. Frankly, I'm not sure that this has been successfully completed, or even attempted, but I think it's at least possible.

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The bottom line, I think, is that today the relationship among management, boards of directors, compensation committees, shareholders, and regulators with respect to executive compensation has changed in a way that allows for more shareholder input on this subject. In addition, our proposed rules, coupled with innovative tactics by large shareholders, may further alter the balance of power in this regard. Whether this is a good thing remains to be seen.

Conclusion

In summary, I'd just like to say that your views are important. I hope you feel free to contact me about any issue that you feel strongly about that is under our jurisdiction. Thank you for your kind attention; I think we have some time for questions.

The Hon. Roel C. Campos *is Commissioner of the U.S. Securities and Exchange Commission. Previously, he served as an officer in the U.S. Air Force, a federal prosecutor, a corporate transactions and securities lawyer, and the co-founder of El Dorado Communications, Inc.*

APPENDIX C

Roundtable Participants

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The Wharton School, University of Pennsylvania

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Former Chairman and CEO
TIAA-CREF

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Chairman
Richard C. Breeden & Co.
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Beth A. Brooke
Global Vice Chair
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Roel C. Campos
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Securities and Exchange Commission

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President and CEO
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Collette D. Chilton
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Cary Coglianese is the faculty chair of the Regulatory Policy Program and associate professor of public policy at the John F. Kennedy School of Government. Beginning in July 2006, he will be the Edward B. Shils Professor of Law and professor of political science at the University of Pennsylvania, where he will direct the Penn Program on Regulation. He will remain a senior research fellow at the Mossavar-Rahmani Center for Business and Government at the Kennedy School.

Michael L. Michael is a senior fellow at the Mossavar-Rahmani Center for Business and Government whose area of interest has been corporate governance and, in particular, the relationship between rules and ethical decision-making. He has spent more than twenty years in the financial services sector, as a lawyer, chief compliance officer, ethics officer, and consultant. His article, "Business Ethics: The Law of Rules," will be published later this year by *The Business Ethics Quarterly.*

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