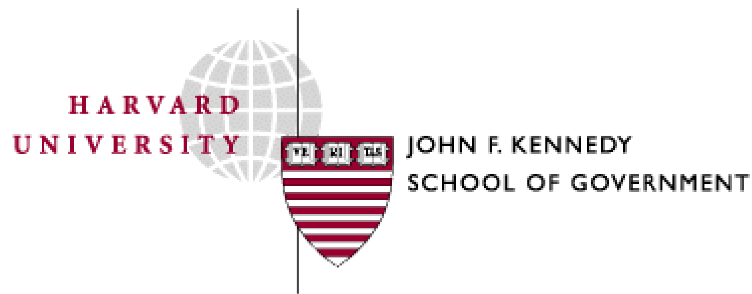


Faculty Research Working Papers Series

# The Role of Government in Corporate Governance

Cary Coglianese, Thomas J. Healey,
Elizabeth K. Keating, Michael L. Michael

November 2004

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# The Role of Government in Corporate Governance

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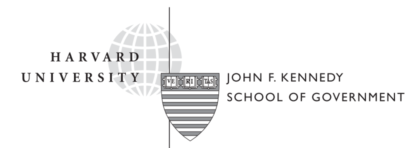

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**Regulatory Policy Program**

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This report represents the authors' efforts to summarize and synthesize the perspectives that emerged at the conference. The views expressed do not necessarily reflect those of its authors, the Regulatory Policy Program, the Center for Business and Government, the Kennedy School of Government, Harvard University, or any of the organizations supporting this project. Furthermore, although this report summarizes the conference dialogue, it does not necessarily represent the views of all the participants nor should it be construed to represent a consensus statement or a shared set of recommendations.



# Introduction

Recent corporate scandals have led to public pressure to reform business practices and increase regulation. Of course, dishonesty, greed, and cover-ups are not new societal concerns. Indeed, much of the existing system of corporate regulation in the United States emerged in response to vagaries of the late 1920s and the subsequent stock market crash. What has changed in recent years, though, is the frequency and public salience of corporate scandals. As a measure of public attention, consider that, in 1998, *The Economist* published no editorials devoted to corporate governance issues. By 2002, it published twenty of them, followed by twenty more in 2003 and more still in 2004.

The public outcry over the recent scandals has made it clear that the status quo is no longer acceptable: the public is demanding accountability and responsibility in corporate behavior. It is widely believed that it will take more than just leadership by the corporate sector to restore public confidence in our capital markets and ensure their ongoing vitality. It will also take effective government action, in the form of reformed regulatory systems, improved auditing, and stepped up law enforcement.

Already policymakers have adopted numerous reforms. In 2002, Congress speedily passed the Sarbanes-Oxley Act, imposing (among other things) new financial control and reporting requirements on publicly traded companies. The Securities and Exchange Commission (SEC) and the self-regulatory organizations it oversees—both the New York Stock Exchange

(NYSE) and the National Association of Securities Dealers (NASD)—have adopted new standards for public companies and securities dealers. The newly created Public Company Accounting Oversight Board (PCAOB) is working to revamp oversight of auditors. Finally, state and federal enforcement officials have responded by aggressively pursuing a number of highly publicized prosecutions against corporate leaders and others accused of violating financial rules.

These responses make clear that the governance of corporations has become a central item on the public policy agenda. The recent scandals themselves demonstrate that lax regulatory institutions, standards, and enforcement can have huge implications for the economy and for the public. Of course, government responses to scandals should be well considered and effective. Regulatory reforms that over-react or that address symptoms while ignoring underlying causes can be costly and counterproductive. Government's task is to restore corporate integrity and market confidence without stifling the dynamism that underlies a strong economy.

To address this challenge, the Center for Business and Government and its Regulatory Policy Program organized a conference in May 2004 on the role of government in corporate governance. The conference brought together government officials, business leaders, and academic researchers to discuss three fundamental public policy challenges raised by recent corporate abuses.

First, the recent corporate crisis has brought into relief the challenge of *who should regulate*. Currently, the government shares regulatory authority and oversight with various non-governmental, self-regulatory institutions. Self-regulation has been prominent in the operation of securities markets as well as in the oversight of the accounting and legal professions. Are



these existing self-regulatory arrangements sufficient? Should government change its oversight of self-regulatory institutions? Or should government assume a greater and more direct role in regulating?

In addition to choosing who will regulate, recent scandals have highlighted the challenge of deciding *how to regulate*. Most broadly, regulators face a choice between principles and rules. Should regulatory standards articulate broad goals or purposes, guiding behavior through the adherence to general principles? Or should regulations take the form of specific rules that tell companies and their lawyers and auditors exactly what is acceptable and unacceptable? Rules have their virtues, and they have been widely used, but they also may allow corporate actors to find ways to comply with the letter of the law while circumventing its spirit.

Finally, regulators face the challenge of deciding *how to enforce* the rules or principles they have adopted. Is more aggressive enforcement needed? Should enforcement officials target just individual perpetrators, or should they also go after the corporations in which misconduct occurs? When should regulators pursue criminal (as opposed to civil) sanctions? Furthermore, since both the state and federal governments have jurisdiction over publicly traded corporations, enforcement officials must constructively deal with jurisdictional competition.

These three major policy challenges framed the deliberations at the conference held at the John F. Kennedy School of Government. This report summarizes that discussion and is organized in three parts: (1) government regulation versus self-regulation, (2) the design of regulatory standards, and (3) regulatory enforcement.

# Self-Regulation

For the past century, self-regulatory institutions have played a central role in policing both corporate behavior and the behavior of the professionals involved in corporate transactions. Since the 1930s, the nation's securities laws have expressly authorized self-regulatory organizations, such as the NYSE and the NASD, to assume primary responsibility for rulemaking and enforcement of securities violations. In addition, the actions of corporate accountants and lawyers have been subject to oversight by self-regulatory bodies.

In light of the recent series of corporate scandals, it is reasonable to ask whether the current structure of self-regulation is adequate. Deciding who should regulate corporate behavior and securities transactions, though, is not merely a choice of either government or self-regulation. Rather, it is a question of when and how self-regulation should be used. What are the conditions under which self-regulation is appropriate? And when it is appropriate, how should self-regulation be structured to maximize its advantages and minimize its disadvantages?

## The Advantages and Disadvantages of Self-Regulation

To some, the term *self-regulation* is an oxymoron, or something akin to the fox guarding the chicken coop. But self-regulation offers a number of potential advantages in the realm of corporate regulation. Conference participants highlighted at least five potential advantages of self-regulation:

1. ***Proximity***. Self-regulatory organizations are, by definition, closer to the industry being regulated. This proximity means that self-regulatory organizations will generally have more detailed and current information about the industry, something that is especially helpful in rapidly changing sectors. By comparison, government regulators are often playing "catch up." Being closer to the action, self-regulators are better situated to identify potential problems more quickly.

2. ***Flexibility***. Self-regulatory organizations can act with greater flexibility than government regulators. They are not subject to the same kinds of procedural and due process hurdles that government is, nor do they face the same political constraints. Governmental regulators do not relish dealing with politically unpopular or extremely complex issues, so these issues can be delegated to self-regulatory bodies.

3. ***Compliance***. Self-regulation may generate a higher level of compliance. The greater the involvement of industry in setting the rules, the more those rules may appear reasonable to individual firms. Self-regulation may also generate rules that solve regulatory problems in ways more sensitive to industry practices and constraints, and hence it may be easier for firms to comply with them.

4. ***Collective Interests of Industry***. Self-regulation can harness the collective interests of the industry. This may be another way that self-regulation promotes compliance, as competitors can effectively "police" each other.




5. ***Resources***. Self-regulatory bodies may have a better ability to secure needed resources. In addition, when regulatory funding is self-directed, the legislature cannot cut it off or use it as a leverage point over the self-regulatory body.

Although self-regulation has these important advantages, it also has some noteworthy drawbacks. Conference participants noted at least five potential disadvantages of self-regulation:

1. ***Conflicts of Interest***. The very proximity that can help the self-regulator acquire useful information can be a disadvantage because of conflicts of interest. Knowing an industry better does not mean that a self-regulator will have the proper incentives to regulate it more effectively. There is also the possibility that self-regulation will be used by older, more established entities simply to keep out market entrants.

2. ***Inadequate Sanctions***. The greater flexibility afforded self-regulatory organizations also means they may have the discretion to mete out only modest sanctions against serious violators. Conference participants noted several instances of self-regulatory organizations imposing small sanctions for egregious malfeasance.

3. ***Underenforcement***. Self-regulators' conflicts of interest and flexibility may also make it more likely that compliance with rules will be insufficiently monitored. If industry's interests are at variance with society's interests, then enforcement by self-regulators might be less than optimal for the overall good of society.

4. ***Global Competition***. In a global marketplace, an industry's collective interest can be defined by competition with foreign markets. If foreign markets are not equally burdened with regulation, then aggressive self-regulation could put domestic firms at a serious disadvantage, providing yet another reason to question whether self-regulators will make socially optimal decisions.

5. ***Insufficient Resources***. Although the funding of self-regulatory bodies may not be susceptible to the whims of legislatures, underlying conflicts of interest could leave self-regulatory bodies with less than sufficient funding.

Clearly, self-regulation has both advantages and disadvantages. It is neither an inherently good nor inherently bad way to regulate corporate conduct. The challenge, then, is to find the situations in which self-regulation is the most appropriate model. After that, the challenge is to find optimal ways of designing self-regulatory institutions.

## Designing Self-Regulatory Institutions

Even if existing self-regulatory institutions receive some of the blame for recent scandals, it does not follow that self-regulation should be abandoned entirely. Instead, the solution may be to change the internal governance structures of self-regulatory institutions, grant them new powers or increase their resources, or modify the degree and type of government oversight they receive.

Self-regulatory organizations can be designed in different ways. Some self-regulatory bodies are stronger and more effective than others. At the weakest end of the spectrum lies a voluntary industry code of conduct for which compliance is voluntary and the industry has little or no enforcement capability. For example, the Association of Investment Management and Research (now known as the CFA Institute) has the power simply to revoke individuals' ability to refer to themselves as "chartered financial analysts." At the other end of the spectrum lie self-regulatory bodies with greater powers both to make and to enforce binding rules. The traditional securities self-regulatory organizations, such as the NYSE and NASD, develop extensive sets of rules and can bar those who violate these rules from participating in the securities markets altogether. In between these poles lie organizations such as state bar associations that possess little regulatory authority but have the power to disbar or exclude, as well as self-regulatory bodies such as the Financial Accounting Standards Board (FASB) that have the power to adopt rules but have relatively little ability to enforce them.



In addition, some self-regulatory bodies are more closely connected with the industry's self-interest than others. Institutions that share responsibilities for both creating markets and regulating them will face an inherent conflict—whether real or apparent—that is absent from institutions that keep regulatory functions separate from market operations. The NASD and, more recently, the NYSE have taken steps to make their regulatory functions independent of their market operations, precisely to keep the regulatory side of their organizations less conflicted.

Finally, self-regulatory organizations can vary in terms of the amount of government oversight they receive. Some self-regulatory institutions are entirely separate from the government, while others, such as the NYSE and NASD, are overseen by the SEC. Government oversight can help overcome some of the limitations of self-regulation, counteracting potential bias while still securing the advantages of self-regulation. Government officials need not know as much as the self-regulators do about the industry, since they are not the principal regulators; they simply need to be able to assess the quality and seriousness

of a self-regulatory organization's rulemaking and enforcement behavior. Moreover, by effectively delegating authority to self-regulatory institutions for routine regulatory functions, government agencies can then utilize their resources for detecting and responding to major rule violations and monitoring for systemic problems.

### Looking Ahead

Despite the criticisms self-regulatory institutions have received in recent years, self-regulation seems here to stay. But self-regulation is changing. Institutions such as the NYSE are undergoing significant structural changes, and the self-regulatory approach to overseeing the accounting industry is being revamped. An important task for the government in the future will be to monitor how well these changes work.



# Rules versus Principles

Both government regulators and self-regulators must decide whether to adopt principles or rules. In response to recent corporate scandals, many commentators have suggested that the U.S. regulatory system is too focused on rules. Although rules can be simple, they also can provide an easy target for manipulation. Some observers advocate a more principles-based approach to regulation that stresses goals and objectives rather than the particular methods of achieving those ends.

Current policy responses to the recent corporate scandals exhibit a tension between rules and principles. The most notable legislative change has been the passage of the Sarbanes-Oxley Act, which has imposed numerous new, detailed rules on corporations. At the same time, the primary accounting standard setter, FASB, has been criticized for relying too much on detailed rules to determine the appropriate accounting treatment and, as a result, has increasingly emphasized a more conceptual or principles-guided approach in its new proposed standards.

### The Strengths and Weaknesses of Rules

In the United States, regulators and industry players often seek refuge in rules. Indeed, industry participants often lobby for a rules-based environment to avoid the unpredictability of later enforcement. Rules are typically thought to be simpler and easier to follow than principles, demarcating a clear line between acceptable and unacceptable behavior. Rules also reduce discretion on the part of individual managers or auditors, making it less

likely that their judgments will be motivated by a desire to achieve personal gain at the expense of investors or the public. The seminal work in this area is the book *Playing by the Rules*, by Frederick Schauer of the John F. Kennedy School of Government, which analyzes the nature of rules-based decision making.

Despite the virtues of rules, in practice rules can be more complex—and, hence, even more murky—than principles. As lawmakers try to address every conceivable eventuality, the rulebook becomes harder to understand and harder to follow. The tax code, for example, is heavily rules-based, and problems often arise when corporations undertake new types of transactions not covered by the code. Determining the appropriate tax treatment can sometimes be quite difficult, leaving auditors with de facto discretion and creating the need for additional rules to clarify inconsistencies or close gaps. Moreover, even simple and clear rules can be manipulated. An effective planner can use the exact wording of the rule to structure transactions in ways that comply with the letter of the law but circumvent its underlying purpose.

**Recent Innovations in Regulatory Design**

Since rules and principles each have their strengths and weaknesses, regulators sometimes try to combine them both in hybrid systems of regulation. Examples include recently adopted international standards governing the computation of risk-adjusted bank capital and the SEC's standards for calculating the fair value of mutual funds. Both sets of regulations rely on principles that the industry must follow in developing and deploying complex econometric models to assess their own compliance.

The international banking community is facing the implementation of a new capital adequacy framework, known as Basel II. Although the underlying document is lengthy and complicated, the framework is based on risk-management principles and relies heavily on the parties with access to the best information. In this case, the regulated financial institutions are deemed to have the best information. Accordingly, under Basel II, banks are responsible for computing their own bank capital and for determining the appropriate level of bank capital (within certain specified limits). The role of the regulator is then to supervise the private parties after the fact. It remains to be seen how well this innovative approach will work. The success of Basel II will probably rest on the ability of regulators to assess the sophisticated econometric models that banks develop and, hence, the willingness of member governments to invest in hiring and educating capable regulators.

In the case of the SEC's mutual fund standards, the issue is how to value fund shares each day. The appropriate valuation of shares is not clear-cut, as some mutual fund holdings are illiquid while others may change in value in domestic after-hours trading or trading on markets around the world occurring after the 4:00 p.m. market close in the United States. The SEC's fair value standard is principles-based in that it stipulates that a mutual fund has an obligation to determine the "fair" value of the shares. As with the banking example, the regulation relies upon the party with access to the best information to determine the appropriate value. Historically, most mutual funds have chosen to use close-of-business prices to determine the fair value of the shares, although a few firms rely on a separate pricing model to value shares when there has been a substantial move in prices since the close of business. For example, some argue that underlying prices need to have shifted at least 2 percent to justify using a price other than the one at the NYSE close. As with the new Basel II standards, it remains to be seen how well this hybrid approach will work.

### The Case of Financial Accounting

Another area undergoing regulatory re-design is corporate financial accounting. The requirements for corporate financial accounting were initially established after the stock market crash in 1929. At that time, corporate financial statements were often not audited, accounting followed industry practice rather than rules, and the poor quality of financial reporting was thought to be a significant factor leading to the stock market run-up and collapse. In response, Congress passed legislation that requires industry to disclose regular financial statements that have been audited by external parties.

Outside investors require financial and accounting information that is both reliable and has been verified by auditors who are independent of management. Traditionally, accounting and auditing practices in the United States have been governed by detailed rules. However, as recent scandals have shown, transactions can be structured to circumvent the rules. Enron's extensive use of special purpose entities, for example, enabled the company to avoid reporting consolidated information about high levels of debt.

In the wake of these scandals, some observers have proposed an alternative, hybrid approach to financial accounting standards, one that asserts an overarching principle that relevant and useful information should be reported. A move to a more principles-based system of accounting standards, however, will face several important challenges.

First, many accountants are not sufficiently trained to make the requisite business-based judgment calls. Hence, under a principles-based system, many accountants could need to undergo significant training to acquire new skills.

Second, corporate executives are encouraged, principally through compensation arrangements, to maximize shareholder value in the near term. For principles-based standards to be effective, the economic incentives that can lead managers to disclose unreliable or biased information would still need to be addressed. A restructuring of executive compensation contracts may be needed.

Third, in the absence of clear rules, company accountants may need to exercise a higher degree of professional resolve when the results they are charged with presenting accurately conflict with corporate executives' interests. Outside auditors may similarly need to show greater resolve when faced with client statements that are inconsistent with broad accounting principles. Showing such resolve may be particularly challenging, since auditors and accountants may be less able to predict how regulators or courts will apply these principles in particular contexts.

In the end, notwithstanding the problems with rules-based accounting, businesses, auditors, and regulators may well continue to welcome rules. With the business environment in the United States seeming ever-more litigious, corporate leaders may resist movement toward principles and continue to favor rules as a way of reducing uncertainty and avoiding costly litigation.

### Looking Ahead

Just as the proper balance between government regulation and self-regulation is likely to vary by situation, so too no single spot on the continuum between principles and rules is likely to apply in all circumstances. Both ends of the spectrum have their strengths and weaknesses. Finding the point in the range that is appropriate for a given particular issue will remain a persistent challenge. A move to a more principles-based approach to accounting in the United States will prove especially challenging in the absence of greater political support.

# Enforcement

Enforcement connects in important ways to both of the issues we have discussed. Whether the regulator is a government agency or a self-regulatory organization, its rules or principles must be enforced. As Voltaire argued, "It is well to kill from time to time an admiral to encourage the others." In this same vein, recent prosecutions have had life-altering effects on both individuals and organizations. Jamie Olis of Dynegy, for example, was sentenced to twenty-four years in prison for accounting fraud. Arthur Andersen LLP was effectively put out of business after being convicted of obstruction of justice.

Enforcement not only has major consequences for individual and corporate violators, but it also can affect the overall credibility of a regulatory system. Enforcement actions send a message to the broader public. They both deter bad actors and level the competitive playing field. That said, greater enforcement is not always better, for taken too far it can dampen socially valuable risk-taking. As with any important policy tool, regulators need to know when and how to pursue enforcement actions, especially criminal prosecutions.

### The Role and Limits of Criminal Sanctions

When employees' life-long pensions disappear in the wake of corporate fraud, white-collar crimes can no longer be seen as truly victimless. As perceptions change, one important issue becomes whether victims of white-collar crime are harmed more or less than victims of street crime. Some argue that

employees who lose their jobs or retirement savings deserve to see the government give more than a mere wrist slapping to executives who caused their losses. Others would question the fairness of a system that imposes a twenty-four-year sentence on someone convicted of accounting fraud when defendants convicted of criminal homicide often spend less time than that in jail.

Whether fair or not, criminal sanctions certainly can be effective in deterring corporate misconduct. Corporations, as profit-making enterprises, are accustomed to balancing risk and reward. The threat of a civil penalty may not be adequate to deter misbehavior if corporate officials simply view potential fines as "a cost of doing business." On the other hand, more severe sanctions, such as imprisonment or being put out of business, materially change the calculus. The possibility of going to jail does tend to catch the attention of corporate officials, and is often (though not always) enough to derail further contemplation of illegal conduct. Criminal law also empowers other law-abiding individuals—whether the board of directors, senior management, or other professionals—to stand up to less well intentioned colleagues or, at a minimum, to resist going along with misconduct.

Yet criminal law is no panacea. First, many of the agencies that regulate business conduct lack the authority to impose criminal sanctions. For example, even though the SEC, the PCAOB, and the Office of the Secretary of the Commonwealth of Massachusetts play key roles in overseeing important corporate activities, none are authorized to seek or impose criminal sanctions. Second, criminal sanctions such as fines and imprisonment cannot provide restitution to shareholders, employees, vendors, or others injured by corporate misconduct. Third, not everyone will be deterred by the threat of criminal prosecution, as some people are prepared to accept a short prison sentence




rather than pay back personal or corporate profits. Finally, criminal sanctions may raise the stakes so high that they unintentionally chill legitimate and economically beneficial conduct. For these reasons, effective enforcement is likely to depend on the continued use of civil penalties combined with the selective use of criminal sanctions.

### The Organization as Defendant

Many of the strategic decisions facing prosecutorial and civil enforcement staff will be the same whether sanctions are criminal or civil. One of these decisions involves against whom to file an enforcement action. Enforcement officials can pursue just the individuals who actually engaged in the underlying offense, or they can name managers or the board of directors for failing to supervise properly, or they can even go after the corporation itself.

One conference participant noted that major scandals foster a "lynch-mob mentality" that drives both the public and enforcement officials to want to pursue the people at the top, regardless of whether they have done something warranting punishment. Deciding who to prosecute ultimately calls for judgments about fairness and reasonableness. Charging the corporation, for example, may do much to deter others in an industry, but it may also negatively affect many people beyond those who violated the law. This concern is especially palpable in the case of a criminal indictment, as shown by the demise of Arthur Andersen; however, it is also relevant in civil cases since large punitive fines may put a company on the brink of financial ruin.

In deciding whether to charge the corporate entity, enforcement officials should consider the nature of the underlying conduct in relation to the overall operations of the business. It is easier to justify criminal or civil sanctions against the organization when the organization—and not merely the bad

employee—benefits from the misconduct. For example, an antitrust violation by which a company increases its profits is a better candidate for an organizational prosecution than a case of embezzlement by an employee that benefits the employee only (and in which the company is itself a victim).

Another factor to consider is whether a corporation has systemically failed to supervise its officers and employees. Companies' boards and senior management are responsible for the overall culture of the organization. They must put in place procedures, training, and monitoring that are reasonably designed to prevent and detect violations of regulations. Recent legislative developments require that public companies implement such steps, including (1) a code of ethics, (2) certification of financial information by the chief executive officer and chief financial officer, and (3) procedures that empower and protect employees who may wish to report misconduct. Isolated misconduct that occurs despite these safeguards, and of which management was actually unaware, generally would not give rise to proceedings against the company, or even against senior management.

### Federal versus State Law Enforcement

Corporate actors face the threat of enforcement by multiple regulators. When the SEC was created in 1934, states already had jurisdiction over securities matters and they continue to retain much authority. State and federal prosecutors also co-exist with self-regulators such as the NYSE and the NASD. The existence of multiple regulators has long been justified in part on the premise that competition among enforcement agencies enhances deterrence.

The deterrent value of multiple enforcers depends, however, in part on regulations being clear and consistent across jurisdictions. Variations across jurisdictions only give companies opportunities



to exploit the differences. Moreover, a patchwork of inconsistent, sometimes even incompatible, legal rulings can be counterproductive for businesses engaged in interstate or international commerce.

Even when rules are clear and universally accepted, the presence of multiple enforcement authorities can create problems. Political factors may motivate enforcement agencies to insist on being "at the table" to deal with a major crisis. Or different agencies may compete against one another to see which can impose the toughest sanctions. Competition motivated by a desire to score political points can hinder the overall objective of enforcement, either by overly complicating resolution of enforcement actions or by misallocating scarce resources so that other important regulatory problems go neglected.

Finally, it may be difficult to maintain the proper balance between enforcement at the federal, state, and self-regulatory levels when one regulator is perceived—rightly or wrongly—as lax or ineffective. Others will rush in to fill the perceived vacuum. For example, the recent mutual fund lawsuits filed by New York, Massachusetts, and other states against broker-dealers and investment advisers took aim at conduct that traditionally fell within the SEC's province. Those who believe the SEC was insufficiently interested in pursuing leads about improper conduct in the mutual fund industry may well conclude that the state litigation shows the value of enforcement competition. Yet, taken too far, such competition may waste resources and generate inconsistent rulings across jurisdictions.

### Looking Ahead

The existence of multiple enforcers, each facing choices about whether to pursue criminal or civil penalties against either individuals or organizations, makes regulatory enforcement a complicated enterprise. Competition among enforcement

jurisdictions certainly can increase deterrence. However, in the future, continued efforts at coordination among enforcement officials are likely to be needed to allocate limited enforcement resources sensibly and to ensure fairness and consistency in the overall regulatory system.



# Conclusion

The crisis of confidence in America's capital markets, sparked by the corporate scandals of the past several years, has generated widespread debate over proposals for regulatory changes. Underlying these discussions are fundamental policy issues about the role of government in corporate governance. Although these policy issues are sometimes framed as simple dichotomies—for example, government regulation versus self-regulation, principles versus rules, or criminal versus civil penalties—the choices government faces are in fact neither simple nor dichotomous.

What, then, *is* the role of government in corporate governance? It is undoubtedly not any single role, but different roles—that of policymaker, enforcer, and overseer—in different situations. Accordingly, there is still another fundamental role for government to undertake: the role of the analyst, seeking to identify the conditions under which to deploy different configurations of regulatory institutions, standards, and enforcement practices. Given the range of policy issues raised by corporate governance, and the variety of industries and firms involved, government decision makers will need to understand thoroughly the effects that different regulatory actions can have in terms of a range of policy criteria.

On the issue of self-regulation, this means, among other things, considering the effectiveness of self-regulatory organizations as policymakers as well as enforcers. It also calls for careful evaluation of the recent structural changes in self-regulatory

organizations. What impact will these changes have on the credibility and effectiveness of self-regulation?

On the issue of regulatory design, decision makers need to understand better what makes different degrees of specificity and generality "right" for particular types of regulatory problems. They also need to assess whether certain hybrid systems can overcome some of the limitations of rules or principles alone.

Finally, on the issue of enforcement, state and federal officials should analyze why some individuals and organizations adhere responsibly to regulatory standards—and why others do not. Such analysis would help enhance government's ability to pursue optimal enforcement, instead of under- or over-enforcement.

The steps that government has already taken, and will undoubtedly continue to take in the wake of the recent scandals, will affect both the integrity and productivity of the American economy. The success of these efforts will be made more likely with careful attention to the kinds of issues summarized in this report, and with further constructive discussion among the many constituencies affected by the multiple roles that government plays in corporate governance.



APPENDIX A

# Conference Agenda

## The Role of Government in Corporate Governance

**MAY 19, 2004**

**Welcome and Introduction**

**John G. Ruggie**, Kirkpatrick Professor of International Affairs and Frank and Denie Weil Director, Center for Business and Government, John F. Kennedy School of Government

**Keynote Address**

**John A. Thain**, Chief Executive Officer, New York Stock Exchange

**MAY 20, 2004**

**Opening Remarks and Introduction**

**Cary Coglianese**, Chair, Regulatory Policy Program and Associate Professor of Public Policy, John F. Kennedy School of Government

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

**Panel 1: Enforcement**

PRESENTER ................**The Honorable Michael Chertoff**, Judge, United States Court of Appeals for the Third Circuit

COMMENTATORS .....**Stephen M. Cutler**, Director, Division of Enforcement, U.S. Securities and Exchange Commission

**David Brown**, Bureau Chief, Office of New York State Attorney General

**The Honorable William F. Galvin**, Secretary of the Commonwealth of Massachusetts

MODERATOR.............**Michael L. Michael**, Senior Fellow, Center for Business and Government, John F. Kennedy School of Government

**Panel 2: Regulatory Design: Rules vs. Principles**

PRESENTER ................**Howell Jackson**, James S. Reid Professor of Law and Vice Dean for Administration and Budget, Harvard Law School

COMMENTATORS .....**Robert Pozen**, Chairman, MFS Investment Management

**S.P. Kothari**, Head of the Department of Economics, Finance and Accounting, Sloan School of Business, Massachusetts Institute of Technology





MODERATOR.............**Elizabeth K. Keating**, Assistant Professor of Public Policy, John F. Kennedy School of Government

**Panel 3: Self-Regulation**

PRESENTER ................**John Coffee**, Adolf A. Berle Professor of Law, Columbia Law School

COMMENTATORS .....**Richard G. Ketchum**, Chief Regulatory Officer, New York Stock Exchange

**Robert K. Steel**, Senior Fellow, Center for Business and Government, John F. Kennedy School of Government

**Elisse Walter**, Executive Vice President, Regulatory Policy and Programs, National Association of Securities Dealers

MODERATOR.............**Cary Coglianese**, Chair, Regulatory Policy Program and Associate Professor of Public Policy, John F. Kennedy School of Government

**Closing Remarks**

**Richard C. Breeden**, Chairman, Richard C. Breeden & Co.

APPENDIX B

# Keynote Address

**John A. Thain**
Chief Executive Officer, New York Stock Exchange

Thank you Professor Ruggie. It's always a pleasure to return to Harvard. It seems hard to believe that it has been twenty-five years since I graduated from Harvard Business School.

This evening, I would much prefer to have a dialogue rather than to consume all of our time speaking. So I'll discuss two broad issues before opening up the format for questions.

Those issues are, first, life at the New York Stock Exchange, and, second, the impact of Sarbanes-Oxley on U.S. companies coming to market in a more competitive global environment. The law also appears to be influencing foreign companies in their decisions on whether or not to list in the United States.

The New York Stock Exchange is comprised of 1,366 members and each one of those members has opinions about what we should be doing. When I arrived at the Exchange we were in a state of crisis brought about by a fundamental failure of governance, and we wasted no time setting about making things right, starting with restoring the integrity of the NYSE.

The New York Stock Exchange is a very big part of the U.S. economy. We have a market cap of approximately $18 trillion, and we are five times bigger than the next biggest exchange. We offer the best prices, and we have an 80 percent market share on listed stocks—all of which enable us to provide the deepest

liquidity, the lowest volatility, and the best execution price. Some 85 percent of Fortune 500 companies belong to the New York Stock Exchange; they are the best-of-class companies.

We know that good corporate governance is critical and the New York Stock Exchange has not set the best example. So, we are focusing on transparency, leadership, and a regulatory function that is guided by integrity.

What are we going to do as we go forward? We have built a new corporate governance structure based on three core principles: independence, separation of key functions, and transparency.

The first is independence. Without it, good governance is elusive, if not impossible. The structure of our new board was approved by our members and by the SEC. Responsibility for governance, compensation, internal controls, and supervision rests with board committees that are independent from New York Stock Exchange management, members, member organizations, and listed companies. Board members may not hold seats and no current CEOs of listed companies serve on our board.

The board has been reduced dramatically in size, with the upper limit having been reduced to twelve. Our current board members are distinguished. In addition to Chairman John Reed, they are Sir Dennis Weatherstone, Marsh Carter, Shirley Jackson, Madeleine Albright, Herb Allison, James McDonald, and Robert Shapiro. I enjoy working with a small, smart, and effective board.

To strengthen stability, we are moving the nominating process for membership inside the board itself. Our members will be elected, and re-elected annually, without term limits.

The second key principle places the responsibilities of governance in the hands of more than one individual. We have separated the functions of the chairman of the board, who runs the board, and the CEO, who runs the company.

The New York Stock Exchange has also created an advisory board of executives that represents different constituencies. CEOs of listed companies are on the board of executives. NYSE members are represented, both those actively trading on the floor and those who have leased their seats to others. Two-thirds of seat holders live outside of the New York metro area and lease their seats.



We also have a new regulatory structure. Our chief regulatory officer, Rick Ketchum, reports to the Regulatory Oversight and Regulatory Budget Committee chaired by Marsh Carter. I have confidence in our self-regulatory organization (SRO) model. No model of governance is perfect; we know that there have also been failures of third-party regulatory bodies. The separation of responsibilities will help the SRO.

We want the structure to work, and not to depend upon any one person. I believe that the New York Stock Exchange is going forward with great people, and we will be helped by an improved structure.

The third and final principle is transparency. We are beginning a new era of openness and disclosure. Our annual report set the new tone with a full listing of our financials. This year, the Exchange published the salaries for its top five employees, something that has never been done before. In addition, all political and charitable contributions are being reported. Granted, we have made only a start, but henceforth the New York Stock Exchange will be an example of good governance.

Now, let me move to a short discussion about listed companies. I'd like to say that we were ahead of Sarbanes-Oxley before it became law. We sought to be in the forefront to help our members avoid a repeat of Enron/WorldCom.

In 2002, the Exchange put together the Corporate Accountability and Listing Standards Committee (CALS) comprised of industry leaders and mostly outside advisers. The group produced thirteen ideas that became the foundation of the

CALS report, which was eventually approved by the SEC in November 2003.

There is a high degree of correlation between the CALS recommendations and Sarbanes-Oxley. Listed companies must have a majority of outside directors; audit committees must be 100 percent independent and list their charters and independent directors.

The passage of Sarbanes-Oxley was vital to restoring confidence in the U.S. markets. What we are hearing, though, is that compliance with Sarbanes-Oxley is proving to be burdensome for small to middle-sized companies. One corporation says that compliance with Section 404 of Sarbanes-Oxley alone will cost it $15 million—a huge financial burden. This is dissuading some companies from going public, and, as the *Financial Times* says today, other companies that are public are thinking of going private.

We are also concerned that foreign companies are opting not to list on the New York Stock Exchange. This results from a combination of Sarbanes-Oxley, two different sets of accounting standards (International Accounting Standards and US-GAAP), and the litigation risk for companies listed here. What's more, the Euro market is now big enough and liquid enough that companies do not have to come to America. All of these factors lead to real concern about longer-term competitiveness of the U.S. markets.

Let me close by updating you on what I have been up to during my first months on the job. My activities have been centered around five major areas of concentration.

First, strengthening the integrity and reputation of the Exchange. The NYSE has 2,750 listed companies and the vast majority are honest, good companies. We want to reinforce the view that when you buy shares of a listed company you can trust it.





Second, specialists. If a company is listed on the Exchange, they are assigned a specialist. From the perspective of the listed companies, it doesn't make any sense not to let them change their specialists, if indeed they want to make such a change. We have made the process much simpler. In addition, institutions have expressed concerns about specialists' patterns of buying and selling. Before, a specialist wasn't allowed to buy before an investor, but they could buy alongside. Now, they can still buy, but only after their customer.

Third, trading speed. We consistently offer the best price for our listed shares, but we are not fast. It takes, on average, about 14 seconds per trade. Many institutions want to trade instantaneously and anonymously. We want to offer that choice to investors and institutions. If investors and institutions want the benefits of the floor, they can go through it, or they can trade electronically.

Fourth, the trade-through rule and best execution. Brokers are required to route orders to the exchange that offers the best price. The SEC has proposed a standard defining markets as "fast" or "slow," and enabling brokers in certain circumstances to bypass a slow market if a better price is available within some de minimus amount in a fast market. I have no problem with that. However, if you have equal execution capabilities, I believe that permitting informed investors to opt out of the trade-through rule is bad public policy. It will distort prices and lead to more fragmentation and internalization. We believe that if execution capabilities are the same, the best price should win.

Finally, consolidation. The question that needs to be asked is: why do all of the regional stock exchanges still exist? Given the challenges of profitability, they are probably not sustainable. If you look to Europe, we see much more consolidation, which is probably the direction that we will go.

To sum up: the New York Stock Exchange is on the right track. We have new people, a new attitude about transparency, and we are making steady progress at restoring confidence in a great American institution.

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**John A. Thain** *is chief executive officer and a member of the board of directors of the New York Stock Exchange. Prior to assuming the leadership of the NYSE in early 2004, he was president and chief operating officer of Goldman Sachs.*



APPENDIX C

# Closing Remarks

**Richard C. Breeden**
Chairman, Richard C. Breeden & Co.

In recent years, U.S. markets have experienced a series of shocks that many would have thought improbable, if not impossible, only a few years ago. These have included the dot-com bubble, an enormous wave of accounting restatements, the collapse of Enron, WorldCom, Adelphia, and other large companies due in substantial part to fraud, improper trading at major mutual fund groups, gross misbehavior among certain stock analysts, and the repeated failure of our accounting system to cope with fraudulent or misleading financial reporting practices. Investor confidence in the system has suffered, particularly from situations where losses could have been avoided if directors, auditors, lawyers, underwriters/analysts, and others had performed ethically and professionally.

The rude nature and sheer size of these shocks have triggered sharp questions for regulators as to why they did not see some of these problems coming and stop them. Government has responded with new laws such as Sarbanes-Oxley, new regulations, and more resources for enforcement at the Securities and Exchange Commission (SEC) and other agencies. State enforcement officials have also played a major role in bringing enforcement actions that highlighted serious abuses and won

major sanctions (particularly in the area of stock analyst behavior and mutual fund sales and trading practices).

Perceptions have changed in the marketplace as well. The post-Enron boardroom is undergoing a reexamination of standards for corporate governance, including greater scrutiny of related party transactions and heightened expectations about the level of effort and diligence that is expected for board members (not that expectations could have been too much lower in some companies). There has been a very noticeable change in climate, with much higher expectations of everyone involved in the governance process than was often the case just a few years ago.

The size of investor losses in some of the worst cases has led to calls for even greater efforts by government to eradicate abusive practices. Although careful analysis of where our system may have gaps is constructive, there is also a risk that in the interests of "doing something," regulatory change can quickly become overreaction. Regulatory overkill is a risk to any sector of the economy, and it must be considered to be a concern equal to regulatory lapses. This conference has been a useful opportunity to take stock of recent governance reforms, and to ask where they may have gone too far as well as where they may not have gone far enough.

In addressing policy concerns, one should not forget that U.S. financial markets remain the envy of the world, and rightly so. Our capital markets are enormously creative and efficient, and we have generally established a strong regime of transparency to allow investors to gauge the risk they take as accurately as possible. Though we do have problems, we do far more things right than wrong in organizing and operating our markets. No other markets can deliver the levels of liquidity and the access to capital across an entire economy that U.S. markets do, day in and day out.



As we look to the future of regulation of the capital markets, the proper role of the SEC is a major unanswered question. It cannot prevent or solve every problem, but the SEC is the crucible where disclosure policies, accounting standards, trading regimes, ethical practices by market participants, and most other vital policies concerning the functioning of our market systems are shaped. To some, more enforcement is the right prescription for the future. I agree with the need for more tools and resources in the enforcement area. However, disclosure policies should not be overlooked as at least an equally important part of the regulatory system. Disclosure requirements help market participants to identify and evaluate risk, and to take steps to protect themselves.

The biggest contribution the federal government makes in the field of corporate governance is in ensuring that investors have access to timely, accurate, and relevant financial data concerning corporate performance, as well as to other relevant and material information that will allow them to make rational decisions. Only in this way can the market as a whole perform its price discovery and capital allocation functions smoothly.

Assuring healthy levels of transparency for investors (both by setting the disclosure standards and by enforcing them) is a major priority. However, government also needs to work consistently to promote competition and to ensure the integrity of the market itself. Our regulatory standards also need to reflect our values as a society in dealing with issues such as business ethics and executive compensation.

This conference addressed three major areas, and in each area there is further research and policy analysis to be done:

- Historically, *self-regulation* has worked better with some sizes and types of issues than with others, and with differing levels of government resources serving as a "backstop" to self-regulatory efforts. Broker-dealer oversight by self-regulatory organizations (SROs) has worked fairly well with SEC backup in the form of inspections and oversight of the SROs, at least in dealing with relatively mundane problems. Review of securities offerings, oversight of accounting principles and audit performance, bank regulation, and the operation of boards of directors (backstopped only by the Delaware courts and private litigation) have been areas where self-regulation has not played a meaningful role. The dynamics at work here are not adequately understood.

- Today's debate of *rules versus principles* in setting accounting standards seems overblown. Traditionally the U.S. system has incorporated elements of both approaches in U.S. GAAP, and I believe this is a good approach. Relaxing the specificity of the accounting "rules" (i.e., FASB statements) in favor of more generalized "principles" has the effect of conferring vastly greater discretion on the accountant performing the audit. This also makes it more likely that there will be higher levels of variation between similar companies based on different subjective assessments by accounting firms, and more pressure on audit engagement teams to give their clients more favorable subjective assessments. Rather than debating these labels as the proper starting point (when both techniques are needed), a more important question would seem to be how best to create high levels of transparency and accuracy in reported financial statements. In this area, when do we regulate, and when do we not? The presumption here should probably remain that government should act in a last resort, not as a first resort; however, creation of the Public Company Accounting Oversight Board as part of Sarbanes-Oxley demonstrated that there is a limit to government deference to private sector efforts if performance is not adequate.

- Finally, there are many areas where *enforcement* actions are essential. Ultimately, the enforcement mechanisms of government put teeth into regulatory requirements. If improper behavior is not checked forcefully, a gradual deterioration in standards will result. Enforcement is a complex system in which both civil and criminal actions can take place at the initiative of either federal or state agencies, as well as private securities actions. Enforcement remedies must have sufficient magnitude to create a meaningful deterrent effect, and market participants must know that the enforcement program of the SEC, for example, will not hesitate to seek any appropriate sanction to control illicit or improper activities. At the same time, there is also a risk that large fines will become "routine" and will lose their deterrent effect if they are seen as becoming commonplace.

Ultimately, any conference about the role of government in corporate governance must recall what government does not do, and should not do. We must remember that ultimately boards of directors are the leading self-regulatory bodies in corporate America. Although boards are held in a place of esteem, many of the most damaging cases we have seen of corporate dysfunction have arisen in significant part because members of the board did not exercise sufficient oversight. Although sensible government programs can reduce pressure on boards, board members must

also be willing to put in the time it takes to understand the issues and to play a meaningful role in disciplining conduct adverse to the interests of shareholders. Thus, in the long run, any steps that help make corporate boards more effective will provide some of the greatest overall benefit.

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**Richard C. Breeden** *is chairman of Richard C. Breeden & Co. In 2002, he was appointed the corporate monitor of WorldCom, Inc., on behalf of the U.S. District Court for the Southern District of New York. He is a former chairman of the U.S. Securities and Exchange Commission.*



APPENDIX D

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**Elizabeth K. Keating** is an assistant professor of public policy at the John F. Kennedy School of Government. Her research focuses on nonprofit and governmental accountability as well as issues of financial distress. Prior to joining the Kennedy School, she taught accounting at Northwestern University, New York University, and Columbia University.

**Michael L. Michael** is a senior fellow at the Center for Business and Government. A lawyer and financial services industry consultant, he has spent close to twenty years as an executive at securities firms, most recently as senior vice president and chief compliance officer and ethics officer at Fidelity Investments in Boston.

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