Restoring Trust in America's Business Institutions

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(Editors)

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Restoring Trust in America’s Business Institutions

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Margaret M. Blair
and
William W. Bratton, Editors
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INTRODUCTION

PROFESSOR MARGARET BLAIR: Good morning. I'm Margaret Blair. I'm the one who convened this gathering. I wanted to express my appreciation to all the people who agreed to come to be speakers or panelists, all the moderators who agreed to help out with the program. And to all of you who came just to listen and observe, I don't want you to just listen and observe; I am hoping you will bring your own insight and ask questions of some of the panelists.

It was almost two years ago when Enron Corporation sought protection from its creditors through the bankruptcy court. This was after six or eight weeks of bad news about the company that had been dribbling out in the newspapers. The full details of the Enron case are not yet out. But the details that have come out so far, throughout 2002 and into this year, have astounded many of us. As Enron went down, it took down the accounting firm Arthur Anderson, a firm that had been known as a pillar of professional ethics for many years. During the last 18 months or so the accounting problems that have been revealed at company after company have left us all shaking our heads. I had one reporter say to me the other day, "The shoes keep dropping." And having recently read the Harry Potter books with my 11-year old I had this vision of this centipede-like monster lurking in our business system with shoes that kept dropping.

When I began to organize this conference last spring I have to admit that I had a selfish concern. And that was, What if it all goes away? What if the economy rebounds and the big cases have all settled quietly? And all the concerns we have about legal ethics and problems in our business institutions recede into history? When it gets to be November 2003 and we hold this conference will it seem dated and no longer relevant? I note sadly that this has not happened. During the last six months we've seen massive accounting fraud uncovered at HealthSouth Corporation. We've seen serious accounting problems and possibly fraud at Freddie Mac. Over the summer that most venerable symbol of American capitalism, the New York Stock Exchange, came under fire for problems that appear to have arisen from failures of corporate governance in that organization. And now we're seeing problems in mutual funds, one of the places we thought were safe places for small and middle class investors to put their savings.

So our conference topic today, Restoring Trust in America's Business Institutions, is both timely and urgent. Over the next few days we will undoubtedly talk about what went wrong. I hope that what we'll do at this conference is talk about what has been done so far to try to fix things and what still needs to be done, what has to change in order to prevent other episodes of scandal in the future.

Before we get underway with our first panel, I want to introduce Judy Areen, our dean, and then my colleague, Bill Bratton, who joined Georgetown University Law Center last summer and has been the faculty director for the Sloan Project since he came.

DEAN JUDITH AREEN: Thank you. Good morning everyone. Welcome
to our conference on Restoring Trust in America's Business Institutions. I would like to begin by thanking everyone that has made this conference possible. I want to single out the tremendous work of Professor Margaret Blair. My thanks go as well to all of our speakers and our panelists and to all of our participants for making time for this conference in your busy schedule. I would like to thank the Sloan Foundation for their ongoing support of our Project on Business Institutions and of this conference.

Our colleagues in the medical profession have a tradition they call "grand rounds" that they conduct following a particularly difficult medical case. During grand rounds the physicians first review both the disease or injury involved to better understand its nature. They also review the response, or lack thereof, of the medical professionals who were involved in the case. The goal in grand rounds is to improve everyone's understanding of the problem and to be better prepared for future such cases. I think that tradition may provide a useful model for what this conference might accomplish. From Enron to Tyco to HealthSouth we have been living through a drumbeat of scandals and misjudgments that have shaken the confidence of both investors and the general public in too many of our business and financial institutions.

There are several reasons, in my judgment, why it is particularly appropriate to host this gathering at a law school. First, lawyers have been involved in many of the problems we will be considering, both in their traditional roles as advisors to corporate and financial institutions and, unfortunately, in some instances as accused participants. Second, lawyers and legal academics have historically been a source of new and improved rules and regulations designed to avoid problems in the business and financial sector. Lawyers have also helped to design and staff new regulatory institutions such as the Public Company Accounting Oversight Board as well as to renovate some traditional ones such as the New York Stock Exchange.

I look forward to the presentations and to the discussions we hope will follow. The talent and experience Margaret gathered for this conference puts you in a unique position to analyze both why things went wrong and to devise more appropriate responses.

PROFESSOR WILLIAM BRATTON: Good morning and welcome to our conference on restoring trust. I'm Bill Bratton, the director of the Sloan Project.

Here at the Sloan Project we follow the very best governance practices. That means that the chief executive officer and the chairman of the board are different people. Here at Sloan at Georgetown the chairman of the board is called the director. So what I do is support my chief executive officer, Margaret Blair. I chair her meetings. I offer her my very best counsel. I ask her endless critical questions and otherwise monitor diligently. The plan comes from Margaret. It's a privilege to serve as chair for her academic enterprise, for Margaret has done more than any other legal academic to redirect our thinking about the theory of the firm and the structure of rights and duties in corporations. Today Margaret gathers us to ask hard questions about corporate governance at a time when the issues weigh heavily. I think it's a good time to join her in taking a fresh approach. My thanks also to the Sloan
Foundation and its program director Gail Pesyna for their support of this enterprise, which has been both generous and stalwart.
PANEL I
WALL STREET'S ROLE: PRICE EFFICIENCY AND THE INCENTIVES OF MARKET INTERMEDIARIES

PROFESSOR DONALD LANGEVOORT: Our first panel is simply titled, "Wall Street's Role," a very broad topic. The panel was envisioned last spring in the aftermath of publicity and reform efforts relating to investment analysts research. We have now seen a global settlement, 1.4 billion dollars; major changes in the industry; work on the part of the self-regulatory organizations, the SEC, the State of New York, various other state attorneys general, and the Blue Sky office all coming together to a major reaction to a crisis. Since we envisioned this panel, the question of Wall Street's role has now expanded as we were faced with a broad discussion of the mutual fund industry.

Discussions about investment analysts, mutual funds, and a variety of other topics touching on Wall Street's practices all raise a question that lots of investors ask: "What am I supposed to think about the people who are working on Wall Street?" Is fiduciary responsibility just a quaint, archaic term that people throw out when, in fact, a culture exists in Wall Street that is sales oriented? That culture attracts a lot of people who are street smart, always looking for an edge, trying to generate money, and for whom "fiduciary responsibility" is a foreign phrase generally seen in compliance manuals and not terribly important to what they're all about. That's an overstatement, perhaps. I would encourage various members of the panel to talk about that if they wish. At the Sloan Program here at Georgetown we're very interested in corporate cultures and industry cultures. So one of the questions you can take over the one I just posed is: Not only does Wall Street attract people who are gamers, who are always looking for an edge, and who have the mind set very inconsistent with putting somebody else's self-interest ahead of theirs, but whether that attraction of people has created a culture in some firms that is largely resistant to lectures about fiduciary responsibility, cultures that make compliance very, very hard work.

Our panel is indeed distinguished. First, well known to many of us at Georgetown and the academic community, Lynn Stout, professor of law at UCLA Law School, formerly professor of law, Georgetown University Law Center, who has written extensively on topics relating to investor confidence, stock markets as casinos, a variety of other rhetorical devices that I'm sure she will employ as she takes us through this question of what investors are to make of the scandal.

Secondly, Ed Kwalwasser from the New York Stock Exchange. He is group executive vice president of the New York Stock Exchange, formerly an official at the Securities and Exchange Commission. Ed has long worked in the area of compliance and regulation in the securities industry.

Our third speaker is Tom Selman, senior vice president, National Association of Securities Dealers, in charge of investment company corporate financing issues. Like Ed, Tom is a veteran of the Securities and Exchange Commission, has worked extensively on regulatory and compliance issues, and obviously has had some experience in the last few weeks dealing with the latest of our scandals in the world.
Finally, Eric Dinallo. I could give his title as managing director of regulatory affairs at Morgan Stanley, which is good reason to have him on the panel, but that's not why he's here. Until fairly recently, about eight weeks ago I think, Eric was chief of the Investment Services Bureau in the New York Attorney General Office. There he was Elliot Spitzer's principal lieutenant on issues relating to analyst conflicts of interest, the global settlement, and the various reform issues.

PROFESSOR LYNN STOUT: Thank you, very much, for this opportunity to talk about the role of Wall Street in recent events and what, if anything, we can do about it. I'll note that the formal topic was, “Can Wall Street analysts be relied upon for independent analysis? Does it matter for the market to be ‘fair’ or ‘efficient?’” I hope my hosts won't mind if I shorten that to a single and somewhat different query, which is, “Does it matter if Wall Street analysts can be relied upon for independent analysis?” I will also note that when Don invited me to speak on this panel he said that instructions were to be provocative. Of course I do this most reluctantly.

I sat down and asked myself the question, "Does it matter whether Wall Street analysts can be relied upon for independent analysis?" And my immediate reaction was that the answer to this question had to be both yes and no. Let's start with the no's. I think for a certain group of investors it is not particularly important whether or not the analysis that comes out of Wall Street firms is, in fact, as Fox News would put it, "fair and balanced." And the group of investors I'm talking about are, of course, the institutional investors.

Now, I can't claim to have done an exhaustive, empirical study. My views are influenced strongly by at least the following two factoids. I remember having a conversation with a mutual fund portfolio manager in 1999 where he was bemoaning the fact that he had not moved more of his funds portfolio into tech stocks. I asked him, "Well, are you planning to do it now?" And he said, "No. One of the rules I was taught early on was never follow one mistake with another mistake." By which he meant that it was clear he had made a mistake by not jumping on the bandwagon and riding the bubble up. But he didn't want to compound his error by jumping into the tech stock market at a time when he clearly perceived it to be a bubble. I was very impressed at that time. Having been an academic trained at Yale Law School in the Chicago law and economic tradition, I had been trained to believe that people who actually operated in the financial industry clearly didn't know as much about it as finance professors. And here was someone who seemed to have the same opinion as I did, which, of course, I thought at the time was the intelligent opinion.

The second factoid comes from a survey that Robert Shiller reports in his book, Irrational Exuberance. The survey was taken sometime in 1999. According to the survey, over 70 percent of the institutional fund managers surveyed believed that the stock market as a whole was caught up in a speculative bubble. This leads me to at least contemplate the possibility that these were not the folks who were misled by the overly optimistic news that was coming out of the financial analysts offices in New York. They were not paying attention to financial analysts; they were paying attention to the retail investor. So as to the professional money managers, it's
But what about individual investors? Let us not forget that although the individual investor has been predicted to become an extinct species for at least the 20 or so years that I have been in the business, they refuse to go away. Fifty percent of the market is still held by individuals. And, of course, the views of individuals very much influence how much money goes into the institutional portfolio manager's portfolio. When it comes to the views of those individual investors, does the news coming from Wall Street make a difference? And here, I'm afraid, the answer may be yes. At this point I'm going to indulge in a little overstatement. When you look at the behavior of individual investors it's very hard to escape the occasional thought that these people are crazy. But let's avoid overstatement and assume they're not crazy. I think it's perfectly safe to say that the average individual investor is very, very uninformed about what's going on in the market and about the actual economic value of the investments in that investor's portfolio. And it's not necessarily crazy for them to be uninformed. Now, I can look at a prospectus and I can make some sense of it. Why? Because I took a lot of economics courses at Princeton and then took more finance courses as a graduate student at Princeton. I can read a prospectus, I can understand what's going on, and I can do a little bit of analysis that would tell whether or not this is a good investment or a bad investment. Although if you were to give me the choice between analyzing a prospectus and getting my teeth cleaned it's not clear which of the two activities I would prefer. But the vast majority of people have not taken courses in economics or finance; they don't understand the basics of accounting; they don't follow what's going on in industries. Their idea of a good time is not necessarily to crack open the Wall Street Journal in the morning and read what has transpired in the business world. And many of these investors not only would prefer to get their teeth cleaned, they would probably take a root canal over reading a prospectus. In other words, these people are desperate for some expert somewhere who will tell them what to do. And in a way this is no more crazy than your average corporate executive wanting a doctor to tell her what to do if she has chest pains. It makes sense. Investment analysis is a complicated business that calls for a lot of expertise. It is perfectly natural for the vast majority of people not to want to have anything to do with it and instead prefer to hire an expert. And most of them do--and these experts are, in most cases, retail brokers. Or as they were once quaintly gender sterotypically referred to, "customer's men."

There are in the United States today approximately 250,000 retail brokers. I can round it up to a round half million if we throw in the folks that sell insurance as well. These are the experts that the retail investors are relying on to tell them what to do. When we look at the incentives faced by retail brokers we should not be surprised to learn that sometimes the advice they give their customers is less than perfect. My thesis is that retail brokers misbehave and they misbehave en masse. And what's more everyone knows this. Let's talk a little about why they do it. Economic theory says generally that people tend to misbehave in one or two ways: they're either fools or they're knaves; they either make mistakes in judgment or they are deliberately dishonest. And they pursue courses of action that benefit themselves at the expense of other people. I think there is much to be said, and Don Langevoort has developed this thesis in persuasive detail, for saying that many retail brokers are
fools. They honestly believe that they know what the good investments are and they honestly believe that they know what's best for their clients. And you can see how the brokerage industry is one that would naturally attract people who are optimistic --over optimistic about their own abilities and how people who are more modest might go off to do other things. But I think it's fair to say it's not just foolishness that is going on at the retail level; there's also knavery. And it's predictable knavery. Brokers regularly face situations in which there is a direct conflict between their personal self-interest and the interest of their client. Now for many years the nature of this conflict of interest was fairly obvious. It was the fact that retail brokers and their firms tended to be paid on a commission basis for every trade their clients made. This is a lot like telling doctors they get a percentage of every prescription they write. You're going to expect doctors to be writing a lot of excess prescriptions. And it was generally acknowledged that retail brokers out there were probably advising their clients to buy and sell much more often than was actually good for the patient's health.

Over the last 20 years, however, we've seen the development and the exaggeration of a second and perhaps more troubling conflict of interest. These days, many, if not most, retail brokers work for so-called global brokerage firms like Merrill Lynch, Citibank, Solomon Brothers, Goldman Sachs, and Morgan Stanley. Each of these firms also has an investment banking branch that makes money by advising corporations how to sell stock and advising corporations how to issue debt and by indeed buying the corporation's debt. Other branches of these firms provide what is supposed to be fair and balanced independent analysis for investors. It's almost as if the doctors are now not only being paid a percentage of every prescription they write, but they're employees of the pharmaceutical companies. There is a tremendous conflict of interest within an institution where on the one hand you've got an investment banking department that's trying to help a corporation sell its shares to investors and on the other hand you've got a retail brokerage department that is trying to advise investors which shares to sell. And indeed it was exactly this sort of conflict that gave rise to the problem with Jack Grubman giving glowing reports to telecom companies that Citibank was also hoping to underwrite at the same time Jack Grubman was inviting investors to buy them.

If we want to get to the root of the problem of tainted investment analysis we have to face head on the conflict of interest that is created when retail brokers are working for global brokerage companies that have many other and conflicting interests. What's more, I suspect that almost everyone knows that this is the root of the problem. Nevertheless, no one at the table today, including investors, have much incentive to do much about it. Why? Let's start with Citibank. Why is Citibank not going to be in a rush to solve the problem of conflict of interest and the misbehavior of its retail brokers? The answer is fairly straightforward. There are, of course, some financial institutions that do specialize in providing independent and very objective advice to investors, normally sophisticated investors who generally pay them a flat fee for their advice as opposed to paying a commission on trade. But as long as this is not a legal requirement, there will always be some firms that say, "I'm going to part the fools from their money because if I don't do it someone else will." There is a profit opportunity there. And it is, frankly, unreasonable to expect institutions to walk away from obvious profit opportunities. So we should not be
surprised if the compliance departments of the global brokerage firms are, shall we say, less than thorough and effective in their effort.

What about self-regulatory organizations? What about the NASD and the New York Stock Exchange? Well, it is important for both of these institutions that they offer at least the appearance of investor protection because you don't want to drive the retail investor entirely from the marketplace. But in many ways because of their governance structure, historically the NASD and the NYSE have faced many of the same problems that Citibank has faced. This is in part because institutions like Citibank have a deal of influence at both the NASD and the New York Stock Exchange. Interestingly enough, of course, the NASD has taken steps to try and separate its regulatory efforts from its member services and the New York Stock Exchange is headed in the same direction. But I think if we look back historically it's fair to say that neither institution has necessarily policed the customer's men with anything like enthusiasm.

Next, we get to the Securities and Exchange Commission, which I will optimistically say would like to protect the retail investor but has traditionally faced a tremendous shortage of resources. The folks at the SEC face the following problem. They say, "Okay; there are 250,000 or 500,000 retail brokers out there. We could spend our resources going after each of them, or we could go harass the 200 or so mutual funds that are out there." Given the limitations of their budget and the limitations of the humans who work for them, it's perhaps understandable that the SEC has chosen to go after a few high profile institutions and individuals like Dick Grasso and Martha Stuart rather than really trying to clean up the mess at the level where it really can be best addressed. Jim Feinerman, who teaches at Georgetown, is a scholar of, among other things, Chinese politics. He taught me the phrase "Kill the rooster to scare the monkeys." It was apparently frequently the practice of the communist party when faced with what they perceived was a problem that was endemic to a group, to find a few high profile individuals to do terrible things to on the theory that if you kill the rooster who was in the barnyard you would scare the monkeys who were in the trees. I suggest to you the SEC is pursuing a policy of killing the rooster to scare the monkeys because they can't reach the monkeys, the 250,00 to 500,000 retail brokers who are in the trees. But I'm not sure that the monkeys are all that scared.

Finally to the last group that I would like to suggest has been complacent or at least compliant in all this—the investors themselves. The investing public has not pushed, at least in an intelligent fashion, for regulatory reform. This is an interesting problem and I think the answer here can be found in economic theory and particularly public choice theory. It's very straightforward. Investors are an interest group that is made up of many, many individuals, each of whom has a relatively small stake in trying to clean up the market. Wall Street firms in comparison are relatively small in number and have a very large stake in avoiding serious regulation. The situation is made only worse by the fact that an investor who gets burned by retail broker's advice protects herself in the future by refusing to listen to that broker. In other words, investors are not repeat players, whereas Wall Street firms are. As a cold, calculating law and economics professor, I have to conclude that there are severe political obstacles to the kind of reforms that might actually get to the root of
the problems we've seen.

But, in addition to being a cold calculating law and economics professor, I'm also a congenital optimist. Having pointed out how the glass is half empty, I want to suggest that there are ways in which the glass is half full. We have a pretty good idea of what sorts of steps we could take to fix this problem. I will give you both an extreme proposal and a more modest proposal. Let us take the extreme proposal. It's time to face up to the fact that there are endemic conflicts of interest at the retail brokerage level and that if we really want investors to get objective and untainted advice it's absolutely essential to address those conflicts in the same way that we've addressed the conflicts in the medical profession. We need to come up with a regulatory system that essentially says you cannot lump all of these activities under a single umbrella. If you're going to be advising investors, if you're going to be holding yourself out as an expert, you have to be doing so under circumstances where your personal interests are not in direct conflict with those of your beneficiaries. It is asking too much of people to give good advice as fiduciaries when the only way they can expand their bank accounts is to serve their self-interest.

But, if we are not going to consider such radical proposals, I have a more modest one. If we can't eliminate the conflict of interest let's at least make it more visible. I would like to bring a small skunk to the party with the following suggestion: At a minimum it seems to me it's technologically feasible for us to insist that every retail broker, every customer's man who converses with her clients must make a tape recording of the conversation and must keep it on file. This tape recording must be available for access both by the brokerage firm's in-house compliance office and for a period of two years by the Securities and Exchange Commission. And it must also, in the event of a conflict or a claim made by the investor, be made available to the investor him or herself in an action that would be brought not in front of an arbitration panel under the auspices of NASD or the New York Stock Exchange, but in a court of law. This would address the problem where it really lies, down at the base among those 250,000 to 500,000 retail brokers as opposed to at the top of the hierarchy where it is reasonable and easy for people often to claim that they didn't know what was going on. In other words, the problems are trickling up from the bottom and not down from the top. And if we really want to solve them perhaps that's the area that we ought to be looking.

MR. KWALWASSER: Well, I agree with everything Lynn said so . . . . There are just a couple of things I would add.

The last time I looked at my mutual fund account it had gone down as much or more than the market did. So those mutual funds that don't need the advice of analysts have been listening to somebody else who gave them the same bad advice. So I don't see it as a matter of fact that institutional investors did any better than individual investors in the current market.

Also, the industry is doing things to address the commission problem. The fastest growing part of the retail industry is fee-based accounts where the income depends on the assets that the customer has as opposed to the number of trades that a customer does. Everything has its problems and we're now looking into whether
we ought to go after people who put customers who don't trade a lot in fee-based accounts. Obviously, the salesperson is getting more money by having the customers in a fee-based account when they're not going to trade than they if they just got commissions when they trade.

There really isn't anything that's not going to present some conflicts. And, as the professor probably knows, one of the major arguments when the SEC first began was whether the SEC should allow broker/dealers or separate brokers and dealers. And they decided that they could live with the conflict. Even as it's true that there are conflicts, I'm not sure that the same conflicts that Lynn Stout presented are the ones that are causing problems in the marketplace. In our market individuals, although they may own 50 percent of the assets, only do about 7 percent of the trading. So the institutions really do care a lot about integrity of the marketplace and they do have a voice. They have had a voice on our board. We have committees dealing with institutional traders. We have committees dealing with upstairs traders—the broker/dealers who trade in large amounts. We have a really strong interest in preserving integrity in the marketplace.

A few years ago I was speaking at the German-American Chamber of Commerce in Frankfurt before Germany passed prohibitions against insider trading. One of the heads of the German bureau was complaining that they couldn't raise any money in Germany for small and midsize companies. I sort of ditched my speech and got up after him and said, "Of course you can't. Nobody trusts your marketplace. Nobody is going to come into your marketplace as an individual investor because they know the market is rigged for institutions. And institutions can't buy stock in small and medium sized companies because they would own them. And so unless you project a fair market to everyone, you're not going to have a market that's really liquid and really works."

We've heard about some of the terrible things that have happened in the last couple of years in our marketplace from failures of corporate governance and from failures at broker/dealers. I will mention some things that we have done about it. Almost a year ago we started developing new corporate governance rules to add to all of our list of things companies need to comply with. This was before Sarbanes-Oxley and before the SEC came to us and asked us to look into the matter. We did it because we saw what was happening at Enron. We looked at what was going on in the marketplace. We brought together our outside directors. We brought together other individuals who were not connected to the exchange but were managers of pension funds and managers of other institutional traders. We took testimony over a number of months. We came up with a set of rules that the SEC finally approved just a couple of days ago. And the NASD came up with a comparable set of rules.

Our corporate governance rules will make the majority of directors independent (as defined in our rules). They will require that audit committees be entirely independent, that nominating committees be independent, and that compensation committees be independent. We also now require that the shareholders vote on any equity compensation that the corporation is awarding to officers, directors, or across the whole spectrum of the company, where in the past
we said you needed to have a vote of shareholders only if it's officers and directors. The problem with that from a marketplace point of view remains to be seen. The markets are so liquid that if investors don't like what's going on at a company they sell the shares. They don't wait around until the annual vote so that they can vote and tell the bums they ought to get out of the company. We think that people should feel more comfortable that there is a heck of lot more transparency. And it may be that because of the transparency there will be less abusive plans put forward regardless of who is going to vote on it. So we think that net, net it's good for the economy and will help bring integrity to the marketplace.

Yesterday our interim chairman, John Reed, came forward with a new set of corporate governance principles for the stock exchange. These deal with having a board entirely made up of independent directors. And by "independent" we mean nobody who is connected with the securities industry as a broker/dealer and nobody who is connected with a listed company that trades on the New York Stock Exchange. They'll be academics, they'll be retired CEOs, they'll be regulators from different markets. They could also be buy-side people—they have no connection to securities as such but they're interested in the market. It is going to be very helpful to the regulatory process to have people, even if they're not in the industry, who understand the market. And that's why I was really happy to see that one of the directors is going to be the chairman of TIAA-CREF, Herb Allison, who was also president of Merrill Lynch, and so is somebody who has a lot of knowledge of what's going on in the industry. It's great to have an independent board, but it's also good to have somebody who can help us along and knows what's going on.

We have found that as a practical matter some of the industry people tend to be tougher than some of the non-industry people because they understand what it means to them when somebody violates something. That's an important prohibition, because within the industry integrity really does matter. Merrill Lynch really cares about CitiGroup, because if people are worried about CitiGroup then they say, "Well, what's going on at Merrill Lynch? Do I really want to leave my money at Merrill Lynch?" There's a real community of interest. That's why the New York Stock Exchange was formed. Those guys under the Buttonwood Tree wanted to make sure that when they did a trade the other party was going to be there when settlement day came along. And that's a big part of what we do. We go out and we look and make sure that there's financial integrity.

There is an economic drive for integrity among and between all of the players in the industry because even as everybody may have a little different interest, they all have a common interest in encouraging people to come to the marketplace. The players in the industry understand that people care about regulation, and that they care about insider trading; that when people come to the market they may lose money as well as make money and want to have an equal chance with everybody else; and that people care that insiders, those that have a special advantage, not take advantage of them. We think the analyst rules are important because we want to make sure that people who have essential, market moving information, don't trade ahead of their research, because that could mean that there was somebody taking advantage. We think it's important to do that even though the Supreme Court sort of says, "The markets, they're on their own."
We also think that salespeople are important. We bring lots of cases against salespeople. We have a very large staff going out and looking at what's going on. We look at every single complaint that comes in not only to us but also to all of our member firms. We use them to go and target to see where there are problems within the firm. Merrill Lynch has, I don't know, 300 branch offices and Citibank has 8,000 branch offices, so where do you know to go? You look at where people are complaining and you go to those offices because you want to make sure that you're going after the people that are the biggest problem.

Sure there are people who get away with it--whatever "it" is--for a long time. They're smart people. Money draws in smart people. And some people are smarter than the regulators, there's no doubt about it. Or sometimes the regulators are so accustomed to what's going on, that they little by little come to think that's just the way the industry is. It's not that it goes from X back to A; it's that it goes to X to Y and the next Y. It moves so slowly that you don't realize that the market has changed. So clearly the regulators need to do a better job.

Finally, I think the last thing that would help integrity of the marketplace is that the market keeps on going up. That covers a lot of sins. You were saying that the investors leave; well, it's clear they're coming back. They have very short memories when they think there is a buck to be made.

MR. THOMAS SELMAN: What I thought I would do is first is give general impressions of two of the major themes we've seen over the last few years and then perhaps respond to a few things that Professor Stout said.

Two issues are most important for understanding what's happened recently. The first is the failure on the part of firms to realize the extent to which heightened and frenzied retail activity in the late 90s affected some of their essential compliance requirements. The second is that the scandals we're seeing now go to the very fundamental notion of the law and of compliance.

I will start with the retail investor and mention a few examples. First is the day trading activity we saw in the late '90s. I'm not sure what the true number was, but a significant number of people were leaving their jobs or staying on their jobs and trading throughout the day in order to market time specific securities and gain the small price differentials. Some of the major firms, some of our most reputable securities firms, in a sense got into the day trading business by encouraging Internet activity with very fast processing. Fast processing certainly is good for the markets, but the clear import was that the firms encouraged the retail investors since they wanted them to trade their portfolio very quickly and have a high portfolio turnover. I don't think these firms thought clearly, or if they did they showed amazing blindness about what inevitably would happen when the bubble broke with resulting effects for their reputations or their business. In fact, a lot of these firms actually have pulled out of their Internet sites and gone back to the normal full service brokerage approach to retail customers.

Another example is the research analyst area. Traditionally, research was left for institutions and institutions could take it for what it's worth. I take some issue
with the idea that institutional investors aren't particularly interested in the research. We hear that from institutions all the time. But of course institutions pay an awful lot in soft dollars for research. So it apparently has some significance to them. And, as Ed said, mutual funds sure felt the effects of the bubble, and they had their research and relied on third-party research. But, in the late ‘90s, retail investors began to use research in ways I don't think they ever had before. Again, the investment banks showed amazing ignorance, blindness, or stupidity, depending on how you want to characterize it, by making their research analysts media stars, putting them on the networks and in high profile articles in print media, in order to encourage the interest that was developing on the part of retail investors. I don't think that the investment banks were at all prepared for the fallout from tremendous losses after the bubble broke and for the fact that the research analysts were responsible in many ways for what happened.

Finally, I mention the IPO area. Traditionally, this was certainly not an area that retail investors were particularly keen on. But it became much more of a focus of retail activity in the late ‘90s, because you had hot IPOs with tremendous run-ups in value on the first day. I remember just casually speaking to friends who were very frustrated and who would reprimand me for not making sure that individual investors could get into IPOs. But, of course, many of them did get in. They put in market orders. They thought that they were going to buy at 20, but they bought at 150 and then the stock fell. And, again, I think investment banks were completely shortsighted in considering the effect that this was going to have on the retail public.

So I think that part of the problem comes from retailization in many aspects of the business that were more institutional before. The investment banks and other broker/dealers firms were not thinking ahead at all, not only as to their compliance but also as to what it would mean if the retail investors were harmed by their activities.

The second overall theme I want to mention, one which has caused me a lot of personal distress, concerns the nature of the scandals. We've had scandals in the past where you could argue about accounting measurements and other principles of the law, but what we're seeing now are scandals that go to the very fundamental notion of the law and of compliance. And that's what I find most troubling.

Let me give you a few examples in the research area. Of all the issues with the research scandal the most problematic one is the fact that a research analyst could feel that a stock was a dog and put a $120 target price on that stock and issue a research report. That is so fundamentally inconsistent with the standards long established in the industry that it's hard to believe that anybody could engage in that kind of activity. Another example is the problem in the mutual fund areas. I have been involved with the mutual fund industry for some time, both at the SEC and with their trade association. And it's hard for me to believe that principles so fundamental as the forward pricing rule would be violated by fund management companies. The rule basically says that you get the next 4:00 price, that you can't backward price and therefore take an informational advantage. It’s also hard to believe that fund management companies would take their portfolios and turn them over to hedge funds to create derivatives to trade off the portfolios, or that portfolio managers
would market time their own portfolios. Again, it's so contrary to the fundamental principles of fiduciary responsibility that it's terribly distressing.

It's one thing to parse out subtle legal issues or accounting issues, but to go to something that is so fundamental to a fiduciary's responsibility and to see it flat out violated is extremely disturbing. And I think that's why we as regulators and compliance people in the industry are going to have to focus much more on fundamentals and make sure that the things we assumed were going to be taken care of, in fact, taken care of, if we're ever going to reestablish the trust of the investing public.

I do want to respond to a few things that Professor Stout said. I want to say, first of all, that despite all this, the real concern is the specter, particularly in Washington, that all business will be viewed as corrupt. Because if basic fiduciary principles are being violated, then, of course, the mutual fund industry will be seen as inherently corrupt, the brokerage industry as inherently corrupt, and, in fact, all business as corrupt. And I suppose we can take that approach. But I don't really think that as regulators or as policy makers that's the approach we should take. I think we should look at violations that are occurring, enforce the law and prosecute to the full extent, and make whatever regulatory changes we need to make. But once we assume as either regulators or the investing public that inherently business is corrupt, then, I just don't think we are being accurate.

As a matter of fact--I hope nobody takes offense on the panel--I was thinking during the discussion of conflicts about the fact that really the only professional that I can think of who has no conflict is a tenured professor. But I don't think any of us would want American business to be run by tenured professors. Conflicts do exist. And conflicts have to be managed, there is no doubt about that. But in some instances we assume that conflicts are more significant perhaps than they really are. And sometimes a conflict may work either way.

Let me give you an example. One major issue I worked on was the research analyst issue, in which of course the conflict was the fact that research was being issued in order to help the issuers that the investment bank was representing. Another issue I worked on was the IPO issue. A fundamental allegation there was that IPOs were being priced at such a discount that they actually harmed issuers. The term that is commonly used in academic literature is that money was, quote, "left on the table" so that issuers weren't getting the full value. But, when you think about it, the two conflicts that are first exemplified by the research analyst issue and second by the IPO issue are inconsistent. In the research analyst issue what they're saying is, "Well, they issue misleading research in order to benefit the issuer clients," which apparently was true. In the IPO area they're saying, "Well, they are underpricing the securities in order to harm their issuer clients." Conflicts have to be managed, but it's always unclear where the conflicts are going to fall in any particular case. It may even be that in certain situations the conflicts almost balance themselves in the business activity.

I also want to say, responding to Professor Stout, that it is a little surprising to hear somebody from the Chicago school assuming that registered reps are
inherently after the last buck; that the long-term interest in having good business practices with their customers just doesn't exist; that investment banks are just interested in going for the best dollar they can get in a single IPO; or that customers are so irrational that they're going to continue to go to a broker who rips them off instead of going to another broker or buying directly an index fund or another type of no load fund; or that the market is so inefficient and so corrupt that the only way to solve the problem is to somehow divide up the industry (and I'm not even sure how that would work). I think, again, this gets back to the underlying premise, which is that you have to have a certain level of faith in the integrity of American business --not because people are inherently good, although I happen to believe that, but because businessmen and women realize that without a certain level of integrity they're just going to lose in the long run. It's been proven time and again, that customers will walk.

I also take some umbrage with the notion that NASD, and I'll speak for the New York Stock Exchange as well here, simply operates at the behest of our large members. There is no basis for or evidence to support that assertion. I have worked there since '96 and nobody has ever come to me or would be so stupid as to go to anybody in our senior management or enforcement department and suggest that enforcement actions or investigations be curtailed because of the financial issue. As a matter of fact, we typically find the opposite. There is tremendous alarm and concern in firms when they realize that there is an investigation underway. If they're smart they're willing to cooperate with us-- I don't think any outside counsel or compliance person would recommend that they not cooperate with an investigation. You have to believe that business men and women are going to consider what their long-run economic interests are. So that's my brief response to Professor Stout.

MR. ERIC DINALLO: I want to talk about two overall things and tell you why I think we've gone through a "paradigm shift," a historical paradigm shift that is actually unprecedented in the history of financial institutions. I don't believe, as some of my colleagues sometimes say, that this is sort of a bubble boom/bust scapegoating enterprise. I actually think that at some level financial institutions and the marketplace will never be the same.

I was trained as a trial lawyer. And when you are a trial lawyer they send you to this thing called NITA. It's trial school--the National Institute for Trial Advocacy. They put you in a room with a bunch of documents and some witness statements and you have to come up with a trial strategy in about four or five hours. And it's been my experience that the side that wins is the one that very quickly develops what's called "a theory of the case." Because as is always in the world, there is conflicting evidence, conflicting witness statements, the documents are all over the place and could support different interpretations. Unless you get your theory of the case together, you just are overwhelmed by the data points.

All the firms right now are engaged in top-to-bottom conflict reviews. Everyone is running around trying to figure out where the conflicts are. I am heavily involved in this project, or so I'm told, at Morgan Stanley. And I run around like one of these famous Supreme Court justices who carried the constitution in his breast pocket said, "Well, let me look up the answer." I carry around this theory of the case
because otherwise I'm going to get overwhelmed.

So let me tell you what my theory of the case is from having looked at 150,000 e-mails and the work that I've done. My theory of the case is that conflicts that will get you on the front page of the Wall Street Journal in a bad way are conflicts that splash badly on the retail investor, on what's called often "the investing public." I think this point is important to look into for a moment. If you look at the analyst cases that I had the great privilege to work on, there would not have been forty days and forty nights--I actually counted it, it was somewhat biblical--there would not have been forty days and forty nights of unending press in the Merrill Lynch matter if the investing public had not been severely splashed upon. If not for that, no one out there would have any idea what the following sentence even begins to mean: "that analysts were going on the pitches." This is a completely investment banking topic until you realize that the investing public was being injured because the analyst that had actually been involved in the formation of the deal would then go and speak apparently objectively.

I want to tell you why I think we're in this paradigm shift and how this is being driven and how to look at it. And I'm going to tell you some of the books that I've read that have influenced me on this. One that influences me and that I brought to the Attorney General's Office in trying to formulate things like the affidavit in Merrill Lynch is the book called, The Structure of Scientific Revolutions by Thomas Kuhn. If you haven't read this book or you don't know something about it, I highly recommend it. Kuhn talks about how science goes along in a very static way and then there are these huge spikes in creative activity and the world is never thereafter viewed the same way. And that there is, in fact, almost an obliteration of the prior regime of science. It's not that Newton was sort of bad Einsteinian science or Aristotle was bad Galileo science, it's that they are from different planets entirely. And you cannot extract one from the other.

I believe that something like that is what we have going on here. Everyone goes around saying, "We strictly did follow the rules and the regulations and we got it so wrong." And that's why you see government and regulators doing what's commonly called "regulation by enforcement." There is no marginal movement within the old paradigm that is going to fix the problem. It is essentially a wholesale paradigm shift within the industry that has to be internalized.

The next book that I recommend that really, I think, explains why these cases caught the eye of the public is a book called Art and Illusion by Ernst Gombrich. Now, this book is somewhat like Kuhn in that it talks about how art kind of bounces along very statically and then all of a sudden there is a leap in some societies of great artistic expression while others just stay very static and never quite get there. From what I understand, Gombrich was completely contrary to the view that a leap was some kind of communal expression of the unconscious finally flailing forward and expressing itself artistically. Instead he said, "No, no. These are artists working really hard and some of them finally got tools to express what they all wanted to express." For instance, they got the tool of perspective and then everything just exploded, or they got the tool of three dimensionality and everything exploded.
I think what you see in these enforcement cases is the tool of expression. I don't think Elliot Spitzer's office or any office can make these kinds of wholesale pushes from the other side. Everyone for years was talking about abuses in the analyst area. Everyone knew there were 6,000 buy recommendations and only two sell recommendations. And everyone had been railing about abuses in the mutual fund industry. Levitt had talked about it. Jack Bogle had talked about it. There were not really any secrets about what was questionable. And then the Canary case came out and it had such teeth in it. It was so over the line. It was a tool of expression that gave a face to something that formerly could not be expressed.

The last book is the hardest for me to deal with. The two books I just mentioned kind of help me walk around feeling somewhat optimistic, hoping that maybe I can figure things out and I can see stuff before the regulators slam me in the head. When you're in government it's fun to slam people in the head, and then when you're on the inside of a firm you're just worried about getting slammed in the head. So now I walk around worried about getting slammed in the head. The book is Godel Escher Bach: An Eternal Golden Braid. It was very popular on college campuses in 1980. Everyone was reading it and the author won the Pulitzer Prize. The part about the book that I want to talk about is the mathematician Kurt Godel. He published some work, I think it was in 1931, that caused a paradigm shift. He obliterated to some extent the Principia Mathematica, which was the great work of Alfred Whitehead and Bertrand Russell. The basis of their work was essentially that mathematics was strong enough to describe everything— that if you only had a complex enough system you could probably describe love if there were enough data points for the undertaking. It was thought that we were going to figure everything out if we could just have enough formulae. And Godel came along and he basically proved what is now known as a simple phrase, "no system can describe itself." He said that no fixed system, no matter how complicated, could represent the complexity of the whole. What he meant was, "Okay. You've got this system of math; it's as big as this table and it's complex. But I can show you for every such system there is a proposition that it cannot prove to be right or wrong. There is a provability equation, as opposed to a truth, and that when asked of this system cannot prove itself. It can only prove propositions within it, not without it."

Now, this keeps me up at night and I'll tell you why. Because the entire SRO system, all of compliance and self-regulation and law is in tension. The SRO system assumes that the firms can police themselves. This is like my favorite comic book Watchmen, by Allen Moore. Some of you have maybe heard of it—it was collected into a big book that's taught in English classes right here at Georgetown. You can buy it at the bookstore. It ends with the famous phrase, "Who watches the watchmen?" I don't know Latin, but I practiced this: Quis custodiet ipsos custodes, or something like that. It is kind of scary too because it implies that the compliance officer has a custodial relationship over the watched. This again gets to a fiduciary duty, and I really am at times a skeptic about what compliance can and cannot do, about what the self-regulatory organization can be expected to achieve. And I believe that what it's really bad at and what you really have to fight all the time is the spotting of these paradigm shifts. A paradigm shift is almost by definition something that is impossible to see from within. You have to completely go to a different place, a different place of thought to both effect it and observe it.
What I'm asked all the time when I walk around is, "What's the next Merrill Lynch case? What's the next mutual fund case?" Firms worry greatly about that next case. Compliance departments and legal departments are destined to fight very hard to kind of stay well, well above the boxes in order to see that case. In the Merrill Lynch cases and in all the matters that I saw, compliance did a fabulous job within the box. There was no front running. There was no insider trading that I ever saw. What it did not do very well was to get above the boxes and see how the boxes interacted. The industry, I think, largely came up with like a C or C minus on that. When I lecture to compliance officers I urge them to like go for a walk, have a cigarette, take an extra long shower, and try to step back from what you're doing from inside that compliance box and try to have a longer view of the industry and what you're about. If we can do that, maybe we can make it.

But remember what I said before, which is this theory of the case about the retail industry. I said at the beginning I'm going to try to prove to you that this is not just a boom and a bust and a scapegoating. I believe that the present crisis did not begin three years ago with the Internet boom. I believe it began 30 years ago with what the securities industry calls a “mayday”, when the commission charges for securities trades for the public were deregulated. The brokerage firms all of a sudden could not compete. They had to saddle up with investment banks to have some kind of synergy, a very ugly word now. They basically bought into the inherent conflict of the vertically integrated firm and undertook to manage and disclose the conflict at the appropriate moments. And it is now, I believe, 30 years later that you see the effect of the change. What happened with the Internet boom is a kind of natural excretion of that relationship. And retail investors had their trust violated along the way, and the industry now somewhat accepts this. But, in a different way, the retail investor has now gotten the final word of authority and is now directing our regulations, our government's activities, and our rule-making undertakings. This will last for a while, how long I don't know. However long it lasts, I can tell you from a personal point of view that it's painful. I don't think the industry, and certainly the compliance and law departments, will ever look the same again. So thank you, very much.

PROFESSOR LANGEVOORT: Thank you, Eric. Let me ask the panel if anyone is bursting to respond to anything anybody else said?

MR. DINALLO: I do have one thing to say. I will say to Professor Stout that I read all these e-mails and the one thing that I did note is that brokers to some extent were the unspoken class of victim in the research analyst disaster. There are many, many e-mails that exist where the brokers write to the analysts and say, "I can't believe I trusted you. I can't believe I passed to you my 20-year relationship with my clients and now my life and theirs is a disaster." They're not just making it up. I don't think they're covering themselves. These were things written long before e-mails were ever going to be known to be publicized. So I think that on the margin your thesis is completely correct. But on a larger scale of motivation, I think, that the brokers were as—not quite as, but largely as misled as—some of the investing public. That's sort of like an empirical observation.

MR. SELMAN: I want to add just one thing to what Eric said. I thought his
comments were very interesting. I think one difficulty with the issue of looking above the box at paradigm shifts is that some of the paradigm shifts we've seen are so fundamental. If you were to go to somebody in one of the firms and say, "By the way, do you think that late trading is going on?" they presumably would look to fundamental principles of fiduciary responsibility and would say, "That's impossible. It's so basic that we've got systems in place. We can't believe it's happening." The real difficulty is that when every firm and everybody in regulation has limited resources, do you focus on something that is fundamental to the securities laws and to fiduciary responsibilities, for which there is no perceived evidence that it's happening? We have to figure out some way within firms at a senior level of asking, "Well, what if we're not pricing securities right? Or what if late trading is going on or what if the research analysts are just lying?" But what if things that we take for granted just aren't happening? It's very difficult to do that in a firm with fairly limited resources where you really are trying to deal with issues that you see all the time.

MR. ED KWALWASSER: It's difficult to do anywhere because I think it's been proven that wherever you don't have a compliance system, supervision, or a regulatory response and there is money involved there is going to be a problem. People are going to find it by chance and then they are going to say, "This check came in and nobody ever asked me for it. I'm going to try to do the same thing and do it again." So it's almost impossible to catch everything, unless, as Tom said, you have unlimited resources and you are in every place all the time, which sounds like a dumb thing to do. Resources need to be rationed and some of these things are going to happen. The best you can do is deal with it when it happens, is deal with it quickly, deal with it efficiently, and hope that it's going to be a long time before the next problem arises.

MR. SELMAN: In every firm I think three things should happen. The first thing is that senior people in the firm, not just compliance people, need to be involved in these issues. Hopefully that's happening more and more among CEOs, chief investment officers, and senior people in the firms. The second issue is that when there is some new activity at the firm, as when some product is being pushed to retail investors or retail investors are somehow being affected by it, the activity should be analyzed from every possible perspective for every possible risk. And then third is that occasionally a firm should devote the resources to going back to fundamental issues and say, "Hey, are we doing the basics right in compliance? Let's not take it for granted. We haven't looked at it in a few years. Let's go back and look at it." Hopefully those three approaches will help.

PROFESSOR STOUT: I want to go back to my original point. The very discussion we've just had here suggests the limits of what I'm going to call the top-down approach. The notion that if you put enough pressure on the senior people you're going to be able to control what goes on at the bottom level. Most of the instances of mutual fund late trading we've seen were not countenanced by the mutual fund families. They involved broker/dealers who were taking orders from clients waiting to see what way the market went and then ripping up the tickets. So it was not happening at the very top level in the way you suggested. At the vast majority of mutual funds it's going on at lower levels. And the suggestion that we
can solve this by putting pressure on the people at the top runs into at least two obstacles. One is the problem of limited resources, which you've just mentioned. I don't mean to suggest that the people who work in compliance are not doing their best. It is just that at an institutional level there is every reason to suspect that the NASD as an institution might not be putting the emphasis on compliance and giving the compliance employees the resources they need to do a thorough police job. Part of that might just be the recognition that we've got a limited amount of resources out there in the world. And you're right, you don't want to have every broker with a compliance officer hovering over him or her every day. So limited resources are going to reduce the effectiveness of the top-down approach. The other thing that's going to reduce the effectiveness of a top-down approach are incentives on both the part of the customer's woman--we'll update it a little bit--and incentives on the part of the person at the top of the chain, in this case maybe the mutual fund family CEO, to not talk to each other to develop a plausible deniability. As long as the mutual funds can say, as they have been saying, "We didn't know the broker/dealers were ripping up the tickets at 5:00 p.m. or that they were taking orders at 6:00 p.m. and telling us they had come in at 3:59"; as long as the mutual funds can say, "We didn't know," there's protection on both sides. All of which, I think, goes back to my original point that if you really want to address this problem you have to look at the conflicts of interest set up at the base level, the conflicts of interest that are inevitable whenever you have the same person who is giving the investor advice also getting paid when the investor buys a particular product. But I hope you're right. You're an even more optimistic person than I am.

MR. DINALLO: Apparently.

PROFESSOR LANGEVOORT: We've hit noontime. I want to thank the panelists for starting us off in such a nice fashion.
PANEL II
ACCOUNTING REFORM:
PROGRESS AND UNRESOLVED PROBLEMS

PROFESSOR WILLIAM BRATTON: We proceed to consider the crisis in financial reporting, the evolution of Generally Accepted Accounting Principles, the role of the auditor, and regulatory initiatives respecting the auditing profession. We are very pleased to have with us, first, G. Michael Crooch, a Member of the Financial Accounting Standards Board (FASB); second, George Diacont, the Director of Registration and Inspection at the Public Company Accounting Oversight Board (PCAOB); third, Dennis Nally, the Chairman and Senior Partner of Pricewaterhouse Coopers, LLP; and, finally, Shyam Sunder, the James L. Frank Professor of Accounting, Economics, and Finance at the Yale School of Management.

MR. G. MICHAEL CROOCH: It's a pleasure to be here. I need to give you my standard disclaimer that the decisions of the FASB are made when we're all together and we can all agree and vote. So most anything that I say, although I promise to make it as truthful as I can, must be considered mine and mine alone.

I think it's important for this group to know who we are and how we work. The FASB is not attached or governed by the U.S. government. It's a private organization; a foundation. We have about 16 trustees. Their job is to provide funding and to appoint the members of the FASB. Under Sarbanes-Oxley, our funding has been changed. In Sarbanes-Oxley the legislators decided that we should not be beholden to the people for whom we make our rules. Previous to this, there was an appearance of impropriety because nice firms like Pricewaterhouse would give us money so that we could formulate the rules that they would have to follow—grudgingly at times. But Sarbanes-Oxley provided a funding mechanism for both the PCAOB and the FASB. It's an interesting formula. If you are a public company you take your 12-month trailing weighted average market capitalization and divide that by the 12-month average market capitalization for all public entities. That fraction multiplied by the total of the PCAOB and FASB budget is the check that the company has to write in order to be sure that its shares continue to be tradable. Thus, the FASB is independent in the sense that it operates based on a charge that companies must pay in order to remain public.

There are seven board members. If you are a board member you have to be independent. In effect, you have to retire, breaking all ties with the companies or organizations from which you came. Our personal investments are limited and we have to make filings with regard to our investments. We have a separate staff that's full-time. So we are truly an independent organization.

Our job is to create accounting standards, which offer guidance to companies when drafting their financial statements. We do that in a deliberative process. We create our documents and exposure drafts. We then issue them for exposure, get input, and re-deliberate. It takes four out of the seven members in order to pass one of our standards.
Now, what happened and how much of what happened is an accounting problem? If you look really carefully into many of the scandals, you will see that the scandals happened because of fraud. Often the accounting rules in existence at the time were not being followed. For example, when HealthSouth has a meeting of 16 or 17 people to decide how the firm is going to calculate its earnings, it does not appear to be following the accounting standards that we issued. In some of these cases, investment bankers, attorneys, company officers, and sometimes accountants colluded in an effort to get around the rules. To take another example, Enron allowed a non-paper trail in one instance. According to the published reports, one of the investment bankers actually traveled from New York to Houston so that an oral promise to repay a certain amount could be performed directly by the company's people. I would assert that that's not an accounting failure; that's a fraud.

Were there things that we should have done and have we done anything about them? Certainly. Special Purpose Entities (SPEs) were a mechanism used by many companies. Some investment houses have as many as 4,000 SPEs they use to do their business. SPEs are not evil in and of themselves. In fact, they satisfy many legitimate business needs, such as isolating assets. The vast majority of SPEs are for legal isolation purposes. But these SPEs are consolidated in the companies’ financial reports. The ones that you've heard about and that you have concerns about were those that were not consolidated. What have we done? I don't want to get into a lot of technical accounting jargon, but the real issue was "should the SPE be consolidated with the company and thus the assets and the liabilities show up on the financial statements that Enron or whomever else puts out?" The answer is that under the rules at the time they didn't have to, although there should have been some more disclosure. We have tried to develop some literature that will give guidance for special cases. Entities that didn't have to consolidate under the normal rules, based on equity ownership, will now have to be consolidated. In a normal consolidation, if, say, General Electric owns all of a subsidiary’s stock it then combines those financial statements when it reports, based on its ownership of shares. In contrast, a lot of these unconsolidated SPEs didn't have enough equity held by an outside owner to support the conclusion that the equity participant was, in fact, the one that was in control. I saw one SPE that had a $15,000 investment by the Red Cross, which held all of the voting shares, even though there were well over a few hundred million dollars worth of assets in the thing. Under our new approach, if you have an interest in an SPE and you're either going to receive the majority of the benefits or you're going to absorb the majority of the losses, then you're probably going to be in control of that entity and its activities. Either that or you're dumber than a rock. So we now decide who is involved by looking at the entity's variability, its operations, and its participants.

It's turned out to be a very complicated process because many of these entities are very complicated in and of themselves. One of the things we often hear is, "Why can't you just write some really simple rules?" Well, my first response is that the transactions we're trying to write rules about are, in fact, very complicated. It's hard to write very simple rules about very complicated transactions.

A second major area that we’ve had to examine concerns guarantees. Although there was some guidance in there about reporting on guarantees, it wasn't
well-followed. We have therefore put out a statement that addresses the various types of guarantees. Enron is reported to have guaranteed the equity of an SPE with its own shares. Enron would guarantee to pay for something that would otherwise be a liability by obligating itself to transfer its shares, but not obligating itself to assume another liability or transfer assets. This transaction led to a problem in the literature regarding the definition of assets and liabilities, because Enron didn't record the shares that it would have to pay in the future as a liability. The way we work is that we have a conceptual framework and we put our rules out and make them consistent with that conceptual framework. Every conceptual framework relating to accounting has definitions of assets and liabilities. Our definition of liabilities was that if you had a liability, you had an obligation that you would satisfy by either transferring assets or assuming another liability. There was no mention of equity. To solve this problem, we've put out a document that changes the definition of assets and liabilities such that if, in fact, you are using your stock as a currency, you must show that obligation that you're going to pay with your stock as a liability on your financial statements.

The last thing that we're working on is employee stock options. On this I happen to be what we call the Board collaborator, which means that I'm the Board person who is trying to marshal stock options through our organization. We hope to issue an exposure draft in the first week or two of February that gives an idea of what we think the accounting standard ought to be. We get an awful lot of comments about stock options. CEOs tell us, "This has been the driver of our business. It's the reason people work so hard. It's the reason why we've been so successful in this business. But if you guys say I have to expense them, I'll have to take them away." I have trouble with that. Under our view of the economics, stock options are valuable in that if you receive them you get something of value. We believe that because they are things of value when given to employees, they ought to be expensed and this document is going to try to do that.

MR. GEORGE DIACONT: It's a pleasure to be here. I'm obligated to tell you that anything I say today reflects my opinion and not necessarily the opinion of the PCAOB or anybody at the PCAOB.

I became the Director of the Division of Registration and Inspections on March 17th, 2003. The Division is unquestionably the heart of the PCAOB; it will be the largest division of the PCAOB once we finish hiring in late 2004. When I came to work at the PCAOB in March, our first priority was hiring competent staff. It's very difficult to hire the kind of people we need; people who can go into a corporation or a large accounting firm and to be able to determine whether audits were conducted properly. We need people with current audit experience. My senior people have to be partners from the audit firms and those are the people that I've been hiring. But it's been very difficult. That was our first priority in March and it's still our first priority now.

Before I came aboard, the Board made a fateful decision as far as inspections are concerned. In our first year we only would conduct what they characterize as limited inspection procedures. What they meant by "limited" is that we were just going to look at the Big 4 accounting firms. In the press this "limited" procedure has
been criticized. But let’s put this in context. There are approximately 15,000 issuers. The Big 4 firms account for about 11,000 of those issuers. So these “limited procedures” are directed at the auditing firms that cover 11,000 public companies. They will in fact encompass about 9,000 staff hours. Maybe you think that's not much, but bear in mind that when we fielded our first team to start the limited inspections in June, it consisted of 23 permanent staff and 5 consultants.

We've been hiring since then and we now have a larger staff, but not nearly large enough to carry us into 2004. In September 2003 we opened our New York office, which will accommodate about 50 professionals. In October we announced the intent to open offices in San Francisco, Dallas, and Atlanta and we expect to have these offices operating by January. We've hired and appointed a deputy director of the Dallas office and that individual is right now trying to staff that office.

In November we expect to wrap up the limited inspection procedures that we started in June. By December we will be writing our reports on the four accounting firms. These limited procedures have two objectives. First, we're looking at the business practices of the major firms; in a few moments I'll talk about business practices and how they affect audit quality. Second, we're looking at engagements. We're selecting a certain number of engagements and reviewing them, asking "do they comply with the professional auditing standards?" But we're not stopping there. We're also looking at whether or not the information contained in the work papers and the documentation and the discussions we had with the audit team suggest that the financial statements may be misstated. During this whole process we're also sensitive to the possibility that there may be evidence or an indication of fraud.

What are some of the areas that we've been concentrating on in the last few months? One thing that we would like to understand is the tone at the top. What message is being communicated by the top leadership of the accounting firms? What are the firm's priorities? How does the quality of the audit practice fit in with the firm's priorities? How effective are their communications? In other words, what's the character of the firm that we're looking at?

Partner compensation is another key area and probably one of the most controversial. I've been told at least four times that, "We don't even tell our partners what our other partners make and you want to come in and look at our most sensitive information?" Well, we had to look at this information because what we were trying to do is to determine what the incentives are in the firm. How are the monetary funds of the firm allocated among its partners and what is the basis for that allocation? One argument that has been made is that some firms in the last few years have been favoring the partners that are really good at selling services over the partners who are super-technical people but who may not be so good at selling services. That is something that we're cognizant of while looking into partner compensation. We're also looking at compensation and comparing it with what the firm is saying verbally about its policies and procedures and looking to see whether there are any inconsistencies in connection with what’s being said and what's being compensated.

One other very important area that we're evaluating is how these accounting
firms determine risks. How do they determine the risks of the issuers that they hire? How do they determine risks for the issuers that they decide to fire? How are those risk assessments intertwined with the audit process? How do they determine risk in connection with their internal inspection program? How about the risk of a partner who's not doing his job? How about the risk that in a given engagement the financials may be improperly stated in connection with an audit? How about the risk that there may be fraud that was not detected in the audit?

One question I had when we started the inspections process, and still have to a degree, is "How is it that these accounting firms have put so much money and so much of their resources into their internal inspection processes?" They have some of their best people involved with these internal processes. So how is it that this sophisticated process for assessing risk and for evaluating partners has failed over the last few years to detect some of the major audit busts that have occurred? How have these sophisticated processes failed to detect some of the large frauds that have occurred over so many years? I don't yet have the answer to that question, but that's certainly a question that we're trying to resolve through the inspections process.

Foreign affiliated firms are also important. The board has decided that foreign firms have to be registered if, in fact, they are the issuers that trade on U.S. markets. The board is trying to decide to what extent we will inspect these foreign firms and how we can come up with a scheme for inspecting them that would be acceptable to the countries with which we're dealing. We're currently trying to gather an information base to understand how U.S. firms interrelate with their foreign affiliates. How do they test the audit quality of the foreign affiliates? Is that testing of the quality of the foreign affiliates reasonable? Is it adequate? Does it meet the auditing standards? I don't know how far we're going to be able to go down this path in 2003 because of the limited amount of time left. But we intend to continue the process of gathering information to understand the relationships and the quality control implications for those relationships.

The year 2004 will be a year of full-blown inspections. Beginning in 2004, we'll be examining every year those accounting firms that have over 100 audit engagements as defined by Sarbanes-Oxley. That's eight firms right now: the Big 4, Crowe Chizek, McGladrey, BDO, and Grant Thornton. We will examine all other firms once every three years. As of today my registration department has received about 700 applications—at the present time we've listed about 600. In addition to the 700, I have 300 firms who have requested passwords and IDs. That means that they've started the process of registration. I don't know how many of those are going to register but we have 700 in-house now. So I'm guessing that starting in 2004 our inspections will look at no less than 200 accounting firms; and it could possibly be 300 firms, depending on how many actually end up registering.

Throughout 2004 we're going to continue to look at firm practices, the tone at the top, and the other matters that I've mentioned that relate to the accounting firms’ business practices. But what we're going to do that's going to be a lot different is that we're going to be reviewing a large number of engagements. We're going to examine at least 5 percent of the practice of the major firms and for some of the smaller firms the percentage will be a lot higher.
MR. DENNIS NALLY: I've been Chairman and Senior Partner of Pricewaterhouse Coopers for about 15 months and I have been in the profession for over 29 years. From my perspective these have been some of the most interesting times I have ever spent in the profession. The kinds of changes and the challenges that we've all been through have been nothing short of remarkable. So what I would like to do is to give you a sense of what we see as life after Sarbanes, of what the last 12 months have been like, and of what the trends are that we're seeing develop. Then I want to give you a sense of some of the open issues that I think still need to be addressed and I’d like to look down the road at some of the critical issues that we're trying to deal with as a profession.

First, I’d like to discuss the last 12 months. I will tell you that the changes we have seen in terms of corporate governance and the kinds of things that our clients are dealing with are nothing short of remarkable. Probably more change has occurred in the last year in terms of governance than anything that we've seen in the previous 25 years. Today, committee meetings are much more frequent. The days of having audit committees meet three times a year for an hour a session with a programmed agenda are long gone. Today, you're seeing audit committees meet anywhere between 10 and 20 times a year and the length of those meetings has increased significantly as well. For example, last week I was in an audit committee session that lasted over two-and-half-hours. Equally important, we spent about 30 minutes just with the audit committee, without executive management present. Two years ago that would not have happened. There may have been private sessions with the external auditor but they were often very quick. "Any issues we need to talk about? Move on." Today, audit committees are very engaged in this process and very focused on the right issues. We can debate what was done in the past, but audit committees today are taking their jobs very seriously. They're focused on the company’s risk. They're focused on the right issues from an accounting standpoint, such as where judgments are being made and where significant estimates inherent in preparing financial statements are being considered. They're involved up-front in discussions around transactions that affect a company's financial statements, prior to any release of earnings or information to the public. I've seen a sea change in the corporate governance function, in terms of how audit committees are carrying out their responsibilities.

You've seen some of the highly publicized stories about how companies are really addressing some of the changes from a governance standpoint, with the addition of independent directors on critical committees, such as compensation committees, audit committees, and nominating committees; that's real. You see some trends beginning to emerge in terms of the separation of the role of CEO from that of chairman. Lead director concepts also are getting a lot of discussion in corporate boardrooms today. A year ago, I don't think there would have been such discussions. So, I think there’s been a lot of progress in the last 12 months.

But many organizations are still struggling with what all of this means. For example, you see a lot of audit committees that are actually struggling to understand what their role should be. How far should they go to deal with the whole question of governance versus management? What's the right balance? How much detail do they need to get into? I think organizations are really struggling with that and I
suspect it's going to take some time to work out the right balance as people get more comfortable with their new responsibilities and the new requirements.

From an executive management standpoint, the CEOs today understand that their responsibilities include internal controls and the tone at the top. Two years ago, the conversations that external auditors were having with executive management were all about the business, the direction of the business, investments, strategy, and how all of that affected our responsibilities as the external auditor. Today, the conversations are much more focused on the control structure of an organization. How do they stack up with other organizations? What are the best practices? What's our independent assessment of the control environment? Do they have the right people doing the right things? The conversations that we're having with executive management are very different today than they were 12 to 18 months ago, which is very encouraging.

I still think that there is a huge expectation gap between what the public expects independent auditors to do and what our responsibilities are. Mike Crooch alluded earlier to the whole issue of fraud. That is an area where I think the profession and the standard-setters are not necessarily on the same page in terms of our responsibility to uncover fraud. There is no question that the general public has an expectation that an independent auditor and independent accountant should have that as a primary responsibility. It is a complex issue, in terms of the ability to really detect fraud. It's not even known whether or not you can, in fact, detect fraud, even with the very best procedures and the very best people involved in the engagement. That is an issue that I believe we've got to wrestle to the ground once and for all and get some clarity on. I have a view that if we don't address that issue and clarify for the public what our responsibility is for the actual detection of fraud, there will continue to be a significant expectation gap between what we do as a profession and what the public expects us to do.

I think we still have some significant issues to deal with regarding the complexity of the accounting framework that we use today to prepare and audit financial statements. The environment today is incredibly complex, if you consider SPEs, consolidation, and some of the other unique aspects of accounting that we're all trying to deal with. In many respects we have gone from a standard-setting process to a process that is very much rules-based. This process is very specific and has created more issues than it has solved. I think we ultimately have to get back to an environment where our accounting standards are really based on principles, so that preparers of financial statements and auditors of financial statements can look at the substance of transactions and make sure that the accounting and reporting transparency of those transactions is consistent with the substance. I don't think you can continue to just promulgate and issue rules in the volumes that we're currently dealing with. I think it's very difficult to expect any practitioner to stay current with all of the rules that are out there—which are so specific and so narrow—while actually producing quality reporting.

I think the issue of convergence of accounting standards is one that really requires more debate and discussion. In the U.S. we have the standards being set by not only the FASB but also the SEC and other regulators. We have the international
accounting standards organizations that are also out there promoting standards. We need to see how all of this ultimately comes together, how much convergence there is between the various groups that are really setting standards. That's a key challenge for the profession, the preparers and users of financial statements.

To sum up, I have seen some major changes take place in a very short period of time as a result of Sarbanes-Oxley. These changes have brought the right spotlight, the right focus on some critical issues that, I think, were necessary. But we still have challenges that we need to address. I'm confident that by at least putting those issues out on the table and talking about them we can come to grips with what it is we all need to do collectively to move this forward.

PROFESSOR SHYAM SUNDER: I would like to talk about the use of accounting to inform and discipline markets. Also, I would like to think outside of the box and explore different paradigms and perhaps think about how markets might be able to discipline and inform the creation and operation of accounting institutions. I'll use examples of where market discipline may usefully inform and help accounting institutions.

So let me start with how we might be able to use market discipline to write better standards. First, let’s talk about the writing of accounting standards, the problem that Michael Crooch talked about a few minutes ago. In the United States, over the past 50 to 70 years the securities laws have formally given the SEC a monopoly in accounting standards and informally given a monopoly to the FASB for publicly-held firms. If things keep going the way they are we might also soon see a worldwide monopoly in the hands of the International Accounting Standards Board. The problem that accounting standard-setters face is to determine which of the alternative sets of accounting standards or rules proposed to them is better and to pick the correct criteria for making this determination. One of the better-defended criteria is a preference for standards that reduce the organization’s cost of capital. But the standard-setters have no way of knowing which of the alternatives on the table will reduce the cost of capital. We can, however, use market signals to help inform that decision.

It's possible for us to develop a competitive regime of accounting standards where regulatory authorities in various jurisdictions permit two or more alternative sets of accounting standards to be used by the reporting entities and allow them to choose one of the permitted sets and publish the annual report saying, “This report has been prepared using Standard X.” Thus, we might be able to say “this bank is regulated by a federal reserve bank or a state charter or this corporation’s charter is from Delaware or California or New York” and so on. That method will have substantial advantages in getting better information into the accounting rules. The reporting entities could pay a royalty to the standard-setters whose standards they use and they could provide incentives for the standard-setters to refrain from just writing more rules. We talk about “publish or perish” in academia; if your sole charge is to write rules, what are you going to do? What happens after 30 years? It's not a personal issue or a matter of intelligence. It's a structural problem that we have created and we can use competition to get better standards. Of course, proposing to let ISB or FASB or Canadian Standards or Pricewaterhouse standards compete for
the reporting entities’ loyalty doesn't get you anywhere with the authorities. After all, nobody likes competition for themselves.

Let's move on to the next possibility. Much has been said about who will watch the watchmen. The way we address these infinite regression problems in mathematics is that we look for the fixed point and use algebra and calculus to solve them. In the case of auditing, how many layers of watchmen are we going to have? Well, we can think about alternative ways of solving that problem. Suppose we consider the possibility that we integrate the audit function with the insurance function and remove the audit requirement, the mandatory audit of public corporations. So the board of directors of a public corporation can vote to decide that they're going to publish their report with a financial fraud insurance of $100 million and go to an insurance company and ask for an insurance policy on that. The insurance company will send in their own auditors to verify and will charge a premium. Both the amount of the insurance as well as the premium will be written on the cover of the report. "This report comes with $100 million of insurance and we paid a $5 million premium for it." Or, "This report comes with no insurance and we still had to pay some premium." I think the shareholders can judge that. It will actually provide better signals, better information to the investors than is possible under the current regime. Because I think Sarbanes-Oxley has burdened the board, which has been given an impossible task, and I think that we can use market discipline to help us address that problem.

Third, much has been said about accounting for stock options. The issue was debated in the early 1990s and now we are debating it again. It's on the agenda of the FASB, the SEC, and the ISB. Everybody who is anybody is debating the issue. But suppose we consider using market discipline to address the problem. Consider a very simple rule, perhaps one such as follows: any entity which gives equity based compensation—stock options—to their employees has to declare in their financial statements what it believes the value of those options to be and there are no restrictions on how it places a value on them. It can use the Black-Scholes formula or any other formula. It can dream a number out of thin air and put it down and we are not going to raise any questions about it. The amount that you say the options are worth will be expensed in the income statement and deducted from the tax return. But part of the rule is that whatever you say those stock options are worth, the shareholders will then be entitled to buy unlimited numbers of those options at that price. The investors will make sure that whatever number you come up with is right; it will become right. If Muhammad cannot come to the mountain, the mountain will come to Muhammad. So, what's the problem? Is it that every stock option is different; there are different vesting provisions and so on? It's very easy for Congress or the SEC to pass legislation that compensation options can only take this particular standard form, which is tradable, and that will take care of that.

I think what we're talking about is a mind set, thinking out of the box. Are there any situations in which we can usefully and beneficially use the forces of markets to inform our decisions and improve our institutions? I believe the answer is yes. The three proposals I just listed may or may not be right. Maybe there are weaknesses in them. But let's discuss them, let's examine these and other such proposals to see if institutions can be strengthened.
Just in case you think I'm a market ideologue, let me give you an example on the other side. Take the accounting failures and the auditing failures of the recent years. It's fun for TV cameras to show these guys in trouble or even sometimes in handcuffs and being led off to the appropriate place. But while it might make good TV, I suspect that it is not a bad people problem. Why not? I'm not saying there are no bad people. But we can't design our laws or rules or standards for a world of angels. There are people who are going to have all kinds of motives. I think the problem is that there are bad policies; it's a bad policy problem.

My summary on this is that market criterion was applied in this case incorrectly and we have paid a very heavy price for it. In these two difficult years many of my friends have asked me in all sincerity, "Why can't accountants tell the simple truth?" The fact is that what's true is not simple. We can and should use the guidance, feedback, and information from markets to restore trust in our business institutions. Indeed, we can and should create new types of institutions that can take advantage of market signals but that do not succumb to the failures of markets. With discretionary care I believe we can do that and market discipline can go a long way to find sustainable designs to match society’s expectations to individuals’ self-interest. But we can't depend on regulation and enforcement to implement all of this. As Thomas Paine said, "That government is best which governs least." I still believe that if we apply market discipline carefully, we will have better regulation than that which government on its own could provide.

PROFESSOR BRATTON: We'll now go to the audience for questions.

AUDIENCE MEMBER: Dennis Nally, how much change did you see before Sarbanes-Oxley but after Enron, and how much change did you see after Sarbanes-Oxley?

MR. NALLY: Most of the change I have observed is post Sarbanes-Oxley. Many organizations were trying in the post-Enron environment to assess how best to deal with a lot of the issues that we're talking about, but I think Sarbanes was the galvanizing event. It forced organizations to step back and address their whole internal control structures and to look at their corporate governance activities. Sarbanes clearly was the catalyst.

PROFESSOR CONSTANCE BAGLEY (Harvard Business School): There has been mention of the question of rules-based systems versus just having general principles, a question which has certainly been bandied about a lot. Why does that tend to be discussed as an either/or choice? Could we, on top of the rules base, overlay something akin to the “true and fair” that you see in Britain, so that an accounting firm and the audit committee would have to determine not just whether they followed the specific rules, but would have to step back and see if the transaction in reality is something that is being accounted for the proper way?

MR. CROOCH: My position on this is that the rules-based standards that we have in the United States have been demand-driven as opposed to us providing them as a part of the supply. When we put out documents that we propose for our exposure drafts, we increasingly try to make sure that we know what the objective
of the standard is and we increasingly try to have enough guidance in the standard so that people will be able to apply it. We frequently get long lists of questions from all kinds of constituencies and they ask us to answer in the standards. Auditors, preparers, and others get great comfort from the fact that they can point to something that says "this is the way that you have to do this particular transaction in this particular set of circumstances."

Prior to Sarbanes-Oxley there was a problem. You had CEOs and CFOs that would say to their auditor, either "Show me where it says that I have to do it that way" or, "Show me where it says I can't do that." If you're the auditor you certainly will try to convince your client to do something a certain way but it's a lot easier if you're able to show him or her by saying, "Well, can you understand English? Read this right here." There was a tremendous amount of demand for that kind of language.

In addition, for a long time the SEC went through what I've described as their rule-making stage. It was something along the lines of, "My way or the highway." There was not a great deal of sympathy for preparers and auditors working through an accounting issue who came to a reasoned professional judgment that they felt reflected the economics in accordance with the accounting literature. They would for whatever reason find themselves in front of the SEC and the SEC would say, "Nope, that's not the right answer. And, by the way, you have to restate." Now, you don't have to do that many times before you want to be sure that you have enough rules in front of you that you could point to something that can convince them that you were right.

As you might suspect, I've talked about this a lot. We are to blame because we have succumbed to giving answers when we probably should not have done so. But we do not sit around trying to think up new questions to send, saying "You know, I think it would be fun today if we screw over the public accounting profession. Let's put out something that's different from the way they think it is and see what happens." We don't do that. I'm sure they think we screw them over sometimes but it's not because we're trying to. We're honestly trying to react to what the market asks us for.

PROFESSOR BRATTON: George Diacont, is it really “my way or the highway” over at the SEC accounting office?

MR. DIACONT: Well, the SEC has statutory authority to establish accounting principles. So it's absolutely the case that if the SEC decides that a particular matter is Generally Accepted Accounting Principles, they have the legislative authority to enforce it. But how that legislative authority is administered and practiced varies from commission to commission. I spent 25 years at the SEC dealing with investigative and prosecutory matters and I can say that over the years the SEC has largely deferred to the accounting profession in the establishment of accounting standards. I only know of two instances where the SEC said, "There are no accounting standards in this particular area. We don't like what's there and we're going to establish our own GAAP standards.” The SEC does interpret a lot. When there is a question, the major accounting firms will come to the chief accountant and ask for his determination based on certain facts and circumstances. But most of the
chief accountants, and most of the commissions that I'm familiar with, have operated within the framework of the accounting profession that establishes those standards.

But the question that I really want to answer is whether there should be an overlay, an overlay that presents fairly not just whether something complies with Generally Accepted Accounting Principles. I would argue that we already have such an overlay, at least as far as the auditing profession is concerned. The profession has an obligation under the auditing standards to determine whether the financial statements are fairly in accordance with Generally Accepted Accounting Principles. The problem when you're trying to figure out whether or not a company complies with Generally Accepted Accounting Principles is that the accounting principles are not very precise in a lot of instances. Very few of them are binary, telling you that if you do this you comply with GAAP. The determination of whether the accounting complies with GAAP is done within the context of particular facts and particular circumstances. I heard this debate of whether we should have principle-based accounting or whether we should have rules-based accounting. I always thought that we had a combination of both. Up until now it depended on which GAAP standard you looked at. I don't think it's going to matter one way or the other, at least as far as what the investing public cares about and that's fraud. Regardless of whether you're dealing with principles-based accounting or rules-based accounting, someone who wants to make the financial statements look better than they are can manipulate those statements in a way that makes them fraudulent. The folks that say that there is going to be some panacea--that if we go to principles-based accounting it's all of a sudden going to be a euphoric situation--they're kidding themselves because it's not going to be a solution to it.

PROFESSOR JAMES COX: My question is for Michael Crooch: what changes have you witnessed inside the FASB since the passage of Sarbanes-Oxley in terms of your deliberations, energy levels, and agendas?

MR. CROOCH: What has happened recently is that we have shortened some of our time lines with regard to issuing standards. Only time will tell if that is a good thing. Before I was there, the FASB would get letters from several organizations saying that we were too slow. "How could it possibly take you so long to put out such and such a rule?" Now, we're getting comments that, "You're doing this too fast. Don't you have to look at it more and study it some more before you put this out?" But the system is under a tremendous amount of pressure. In addition to trying to solve the accounting problems that we're working on and in addition to Dennis Nally trying to work on the audit side, corporate managers have been terribly stressed. They're trying to be sure that they get all of the things in place that have to be in place. As a result, I sense that the entire system is under a lot of stress. Everybody believes that they need to get it right, and that's what everybody wants to do. It creates stress to make sure that the audits are done correctly, that the accounting standards have been interpreted correctly, that you get them out on a timely basis, and that they work the first time. There's also stress because people are having a hard time applying them. There is also stress to make sure that you've pushed all of these approvals through the organization so that when the CEO and the CFO have to sign this thing and say, "Everything is all right," they have the assurance of their people. There's a lot in Sarbanes-Oxley that has stressed the system.
AUDIENCE MEMBER: Whenever there are allegations of a failure to disclose a material fact in a disclosure the immediate thought of many lawyers, especially on the plaintiff side, is to bring in the accounting firms because they should have had something to do with that failure to disclose; and these lawsuits seem to be proliferating. Now we have this idea of additional regulations and oversight, which in turn would create further rules that could create more exposure. How would that impact on liability? You've talked about fraud as one of the areas where you don't get involved and the companies don't get involved and they shouldn't get involved, because you can't uncover everything. Would accountants ever propose going one step further, doing investigative forensic accounting—because accountants are going to be sued in many cases anyway for these disclosures? That's the thinking of a lot of law firms. What are the solutions? What are the alternatives for accounting firms concerning these increasingly difficult problems regarding liability in the future?

MR. NALLY: You're absolutely right that it's a critical issue facing all of the firms in this profession. Whenever there is a material fraud, the audit firm is normally going to be there, the last one in line with the checkbook open dealing with the litigation that stems from that. So whether we like it or not, we are, in fact, being held accountable for that detection—or lack thereof. So I think in order to effectively deal with this as an issue there has to be a clear understanding of what it is an auditor does to detect fraud under the existing standards and we need to have a clear understanding as to what the auditor could do in situations where it may make sense to do more from an audit standpoint. For example, there are certain organizations that when you look at the company's business model, its internal control structure, its tone at the top, and the focus of their business, you may find that they create opportunities to let fraud take place in that organization. If that's the case, what procedures should the auditor deploy? Does it make sense to have forensic auditors as a part of that team? How about special procedures? I think that's the next step, the next evolution of this discussion, which is: what should the standard be in those situations? We also must try to get agreement with the standard-setters regarding the standards that the audit firm would deploy to actually deal with the whole question of litigation in those situations. The issue of liability is one of the top issues facing this profession going forward. Today, cost of litigation is my firm’s second largest cost component, right after people. Five years ago it never even made the radar screen. So, the future viability of these firms is really in jeopardy if we don't deal with this issue.

MR. CROOCH: Also, if you really want firms like Pricewaterhouse Coopers to look for fraud, the price tag would be enormous. On top of that, if you get a circumstance where five or six people agree to collude to fool the auditors, they won't find it; it just can't be done.

MR. ROGER CONNER: To what degree did the rising emphasis on short-term share price over the last 10-15 years act as one of the driving forces that has led to what are now seen as shady accounting practices? Especially, Professor Sunder, I’d like to ask about the extent to which that and the change in the market for accounting services has contributed to this, because it seems there may have been a feedback loop. That is, if the accounting firm cooperated with those attempting—intentionally or unintentionally—to manipulate short-term share price
there was a feedback loop, but it wasn't a good one.

PROFESSOR SUNDER: I think your question relates to the rules versus standards issue. There are institutional consequences from the belief that people have come to have in the efficacy of written accounting standards. The usefulness and value of written standards or the belief in such usefulness that is widely held today was not held 50 or 70 years ago. When the term "Generally Accepted Accounting Principles" came in to vogue more than half a century ago there were very few written standards. "Generally accepted" literally meant generally accepted. Today the same term, "generally accepted," has come to mean something which is quite different from the plain English meaning. "Generally accepted" suggests a socially acceptable norm, rather than a fortified body of rules. Yet we don't think twice when we describe the collection of rules written by FASB or ISB as Generally Accepted Accounting Principles. But they are written, enforced accounting principles; these are not necessarily generally accepted and that's part of the problem, in that we have come to rely on this. The other part is the demand from auditor and client relationships. We have a false belief today in the value of reducing alternatives. There is a very broad consensus that if somehow you have a set of accounting rules for general acceptance, with fewer alternative ways of treating a given transaction, it's a better system.

PROFESSOR BRATTON: I would like to redirect the question to Dennis Nally: Was there a client-based demand that you experienced in the late 1990s that was driven by short-term stock price considerations? Was there a change between 2000 and 2003 in the impact of that demand?

MR. NALLY: If we all think back to 1995 through 2000, there was much reference to the new economy, new age companies, dot com this, and dot com that. The pressure on organizations to meet analysts' expectations of short-term earnings and quarterly earnings was absolutely remarkable. We were going through a period of tremendous growth. We would have a company that was expected to report earnings of $1.20 a share. They would roll up their numbers and they would come out to $1.18, and the company would have some analyst ready to downgrade their stock because they missed their earnings by two cents. That downgrade could mean a 25 to 40 percent decline in market capitalization. Does that create pressure on an organization? It absolutely does. But I'll tell you what's really ironic to me as an independent auditor. When a company reports $1.20 a share, there are a lot of judgments that go into reporting that figure--estimates, accounting policies, principles, practices, and so on. For shareholders to discount a company's stock by 25 percent because it reported $1.18 versus $1.20, suggests to me that they really don't understand what's going on in that company. I think that's what really created a lot of problems.

But to sit there and say that this influenced how auditors thought about their role and responsibility is absolutely not the case. The real issue is determining the quality of a company's earnings. Whether the company reports $1.18 or $1.20, it's incumbent upon the auditor to evaluate the quality of those earnings. If they're making adjustments to reserves or other judgments, how does that impact the company's earnings? How do they report that information externally? Are they being transparent with that communication to the public? I think it's the job of the
independent auditor to do that and if they're doing their job well those issues get flushed out the right way.
PANEL III
THE CHANGING ROLE OF CORPORATE DIRECTORS

PROFESSOR MARGARET BLAIR: Our panelists are: Ms. Claudine Malone. She has been the president and CEO of Financial and Management Consulting, Inc., since 1982. And she also serves as an independent director at Aviva Life Insurance Company USA, Hasbro, Inc., Lafarge Corporation, Lowes Companies, Inc., and Science Applications International Corp.

Next is Robert Rosenberg. He was the CEO of Dunkin' Donuts from 1963 to 1998. He oversaw the growth of that company from a relatively small family-owned business into a very widely known and well-loved brand, a worldwide chain of over 4,000 stores, with system-wide sales of over $2 billion per year by the time he retired in 1998. During that time, from 1968 to 1989 when Dunkin' Donuts was sold, a $1 investment made in Dunkin' Donuts on the day it went public and held until the sale of the business in 1989 would have earned investors a 35 percent per year compound rate of return. Bob now serves as an independent director to a number of companies. And in the interest of full disclosure, I will note that Bob and I serve together on the board of Sonic Corp.

Next is Dr. Roger Raber, who is president and CEO of the National Association of Corporate Directors. This organization is, according to their website, the only professional organization devoted exclusively to providing information, research, and education for corporate directors and boards. This is a task that is suddenly in great demand, and demand may grow exponentially in the next few years.

Next is my colleague Professor Robert Haft, who has been on the faculty here at Georgetown Law Center since 1978. He teaches torts, corporations, and securities regulation. He joined the Law Center after a long career of practicing corporate and securities law.

Finally, to my immediate right is Judge Leo Strine. He is a vice chancellor of the Delaware Court of Chancery. Judge Strine joined the Chancery Court five years ago in November of 1998. Since then, he has written a number of opinions that are important for corporate law. Of particular interest to us on this panel is his opinion of last June in the Oracle Corporation derivative litigation case. In his opinion he raises the bar for corporate directors with respect to what kinds of relationships qualify a director as independent for purposes of serving on a special litigation committee. I highly recommend it.

I want to start by asking Professor Haft to brief us quickly on how the Sarbanes-Oxley Act has changed the legal environment for corporate directors, what duties, responsibilities, and potential liabilities do corporate directors now face that they did not have prior to Sarbanes-Oxley.

PROFESSOR ROBERT HAFT: It's not only Sarbanes-Oxley that has changed things for directors. We have to look at the entire landscape, which includes Sarbanes-Oxley, the New York Stock Exchange Proposed Rules, NASDAQ rules, and the recommendations from various private organizations that set a standard for
the state of the art. The private organizations I'm talking about are the Conference Board, the Business Roundtable, the Higgs Report in the United Kingdom, and the American Bar Association resolution in August of this year backed up by a lengthy committee report.

Now, there is a great deal of convergence by these various groups and the SEC in their rules passed under Sarbanes-Oxley as to the expectations respecting directors in the post-Enron era. The expectations are that directors have to be more informed, more active, and more independent than they have been in the past.

Sarbanes has done a lot to at least try to move the ball in that direction, starting with the new monitoring duties of directors. What it adds up to is a lot more information flowing upwards to the directors for decision-making purposes, and a lot of duties with respect to that information. The flip side of the coin is that there is going to be increased liability. When there is more information, there will be more red flags that plaintiffs' class action lawyers can utilize and apply with 20/20 hindsight. The red flags are things that directors definitely should have known and were obvious.

So we've got the plus of getting better decisions from the upward flow of information, better prevention of fraud, better business decisions on the merits, and we hope more transparent financial statements.

Now, what are some of the details about Sarbanes-Oxley’s requirements? It requires review and monitoring of the company’s systems of disclosure, controls, and procedures, and of internal financial monitoring, what accountants call internal controls. What Sarbanes-Oxley and the SEC added to standard internal financial controls are what the SEC labels "disclosure controls and procedures," which means all of the non-financial disclosures.

The company has to set up an entire system in great detail documenting that it has the information that's necessary for disclosure flow from the lower echelons to the CEO and to the CFO who have to certify the accuracy of their disclosure under civil and criminal penalties. And then under Sarbanes-Oxley the directors are going to have to assess the adequacy and efficacy of the disclosure controls that are set in place.

All of this means that directors will be getting more and more information from managing the company that could make it easier for a litigator to say "guilty knowledge for purposes of liability." So they're going to have to review the CEO and CFO certifications of the accuracy of all of the filings and of the fair presentation of the financial statement.

The overriding rule that the SEC and the accounting profession have had for years has been fair presentation: that you cannot mask economic reality behind a bunch of accounting gibberish, you have to have the facts come out. In United States v. Simon, a number of accountants went to jail, despite the fact that accountants—the entire profession—testified that these accountants had complied with Generally Accepted Accounting Principles at the time. The jury convicted them because they didn't show the essential facts behind the accounting language.
The other thing is that the board is going to have to review the officers, the CEO and CFO's evaluations of the overall correctness and accuracy of the internal controls and the disclosure controls. So they're definitely going to be more informed; or even if they're not it's likely to be inferred that they're more informed, for litigation purposes, as to the business and finances of the company.

Let's move to the audit committee. The committee must be composed completely of independent directors. And the audit committee has the absolute obligation to report the detailed information that the audit committee is mandated to know about, these very same facts, to the full board. So that any people who think that the full board is not going to get into the nitty gritty of accounting and financial statements and risk management—legal risks, business risks, and financial risks—they are now kidding themselves.

The New York Stock Exchange, in October 2003, issued new governance standards requiring that the audit committee regularly report to the full board all accounting problems and all accounting issues of which they become aware. And Sarbanes-Oxley made it pretty clear that the audit committee is going to be the absolute center of both the good information and negative information flowing to the board, starting with the whistle blower. Accounting whistle blower complaints must be handled by the audit committee. So right off the bat we're going to have potential red flags for litigators.

Now, obviously everything that the audit committee learns through this process will inferentially be attributed to the board, even if the audit committee does not fully report to the board, which I doubt they will fail to do.

It's not only a New York Stock Exchange mandate but, in my view, general corporate law, particularly Delaware's duty of disclosure, requires that independent directors who are members of the audit committee will have the duty to disclose all of the nitty gritty in great depth with respect to the financial statements. So there are a number of things that would make one worry.

PROFESSOR BLAIR: This sounds like quite a daunting set of changes already. And if you haven't even gotten to the bad stuff I really am nervous! Let me go to Claudine Malone and Bob Rosenberg and ask, in practice, how have your jobs changed? Do you experience your job as being different as a result of the Enron disclosures, the subsequent scandals that we've seen, the Sarbanes-Oxley Act, and changes from the stock exchanges?

MS. CLAUDINE MALONE: I must say Professor Haft has my attention. I serve on the audit committees of four public companies and I chair one of them. And the workload has increased significantly since Sarbanes-Oxley. I think even those of us who thought we were being conscientious before now have new duties which are imposed. There are additional things that are required either by the SEC or by Sarbanes-Oxley, including regulations that concern how we review the quarterly press releases with analysts, and any communications to the rating agencies. Anything that is going to be disclosed in the company's reports to those analysts is supposed to be reviewed and discussed in advance with the audit
committee. So just the amount of paperwork, the number of meetings, and the level of details for these reviews and discussions, increases the workload substantially.

I'm also designated as an audit committee “financial expert.” The mitigating factor on that is that at least the SEC said I would have no greater liability than the other members of the audit committee or, in fact, the other members of the board. Which I interpret to mean we would all be in the same line in jail.

MR. ROBERT ROSENBERG: I would agree. My computer is on overload in terms of downloading material from the three audit committees I'm on. But I have a different take. Even though it's a lot of work, it's mostly in the area of compliance. And my sense is that as useful as it may be it really wouldn't stop a lot of the excesses that have occurred over of the last several years.

So it's an interesting piece of legislation, I think, and it sends a message. And I think the message goes a lot deeper than the activities of the audit committee. We've yet to see any real penalties, or any really massive improvement in the competence with which governance is exercised in a corporation, in terms of tone, involvement, the kinds of activities that directors do, the structure of the board.

I think compliance with Sarbanes-Oxley has limited beneficial value in and of itself. However, that being said, I think it will require a lot of work for confidence to be restored in the work of boards and I think that's still yet to be done. I don't think this legislation really touches on that yet. Boards aren't necessarily doing the right things. They aren't necessarily properly inducted into the companies. Members don't necessarily understand their companies and really can't do their job of governance correctly. What I see is people getting a packet of paper a couple of days before a meeting, reading it on a plane, with the agenda set by the CEO, and then sitting in a room for a few hours and calling that governance.

PROFESSOR BLAIR: Judge Strine, although we all know Sarbanes-Oxley is a federal law and your job is to adjudicate state level corporate law, nonetheless the Delaware courts are where most of corporate law is made for the whole country in practice. And you and your colleagues, both on the Chancery Court and the Delaware Supreme Court have at various times expressed some concern about the incursion of federal law into what had been considered state territory. Alternatively, you've questioned the possibility that you as a state level judge will be called upon, in effect, to enforce federal law in response to shareholder lawsuits. Is it your sense that the job of directors has been changed and that your job as a judge has been changed by Sarbanes-Oxley? And should Bob, Claudine, and I, who serve on boards, should we be worried about these changes? It sounded scary from what Bob Haft said.

JUDGE LEO STRINE: I think it should be less scary in terms of your personal pocket. Look, being a corporate director is not that risky an endeavor compared to almost anything else you do in society. Almost every company has an exculpatory charter provision, which immunizes you, even for gross negligence. Your average cop on the street is exposed, even with governmental immunity, to liability for gross negligence. When doctors make mistakes it's negligence. As a corporate director, you generally can't even be gotten for gross negligence.
I've been on the court five years. I've been pretty busy. I've written a lot of opinions. Not one of my opinions holds an independent director liable for monetary damages. And since the stupid *Van Gorkom* decision, I'm not sure that I know of one that goes there.

So I think it's really just sort of whining about risks. I don't particularly think it behooves people who talk that way--many of whom also say that the poor ought to just get with it and get that third job or whatever. I think, let's grow up. But I think what worries me about Sarbanes-Oxley is it was a political response. The original Sarbanes bill was probably better, but it was bottled up until WorldCom hit, and then you had this gush of every single idea thrown into the bill instead of focusing on the real issue, which was financial integrity of firms, and maybe starting with some good targeted reform and seeing how that works. We got sort of soup to nuts. Everything good people like Ira Millstein ever thought of got put in the bill. We have governance committees, we got nominating committees, we got everything.

We have a motto too. We put a taint on people who own equity. You can't serve on an audit committee if you own, or if you're affiliated with someone who owns more than 10 percent of the company. Now, that's kind of stupid, I think. It's not just targeted at controlling stockholders. Private equity firms, for example, might be the best kind of monitors. Perhaps they brought the company public, and they still have 15 percent, but they can't serve on the audit committee. So you lost a good source of outside directors, which causes frustration.

I'll give you an example. Bob mentioned all the things that the audit committee has to do financially. Most audit committees are set up as the compliance committee for a company--doing environmental compliance, or discrimination compliance. All the compliance is put in one committee of the board. I think it's a real challenge for directors now as business people to ask themselves how do they structure their operations to get done what needs to be done.

I think it would probably make sense, for example, to have a legal compliance committee that is separate from the audit committee. That would free the audit committee to focus on financial integrity while another group of people focus on the other areas of compliance.

I think there has to be a lot of business-like thinking done about the role of the board. And I think there needs to be a better fit between director expertise and the tasks ahead. My test is that you should ask yourself before you go on a board, "How does this company make money?" If you can't answer it, don't go near the company. I'll repeat that. It sounds stupid but, "How does this company make money?" If you go on a board and you don't understand that, you're headed for problems. I think I could have fathomed that Enron was a really hinky company. But I think what happened was everybody thought they were geniuses and they thought they were on a board of a company that was managed by geniuses.

Now, we all know that the trading part of that firm was fundamentally corrupt. It wasn't just the Raptor transactions. I think you had good people on the board. But I would never serve on the board of a business that depended on derivatives to make money. I can't fathom it. I could probably serve on a manufacturing company board.
I also think you're going to have to be on fewer boards. And you're going to have to know something about the business of each one.

I'll finish with one big problem. Under the new model there is one person in the boardroom who knows everything about the company and is really powerful, the CEO. And what do we want for everybody else? That they have absolutely no stake in the corporation so therefore they're wholly independent. If they own stock we don't like that. If they're the company's bankers, we don't like that. So you have the one CEO there, and generally he knows everything. And then you've got 10 or 11 outsiders who are doing this as a part-time job. That strikes me, at best, as a monitoring board. And it also strikes me as a different model.

Most of the money that is now held in equities is held through intermediaries. Most smart investors buy diversified mutual funds, or index funds, and then rely on other people to monitor. To the extent those intermediaries in the private sector are not really playing an activist role, the argument is going to be made that you're going to need more and more governmental regulation. Because until the Fidelities and the Vanguards of the world are actually actively proposing change at companies then there is a real gap in our overall model. And what we've done is we've placed a huge, huge bet on independent directors. They're going to have to step up to the plate and be the victim of a lot of experimentation.

PROFESSOR BLAIR: Roger Raber, what are your members coming to you and asking you about? And what are you telling them now that is different from what you were telling them a year and a half or two years ago? What do they want to know, what are they anxious about and what are the issues that they're most concerned about?

DR. ROGER RABER: Let me just respond to the Judge first. Charles Elson will be here shortly and I think he'll argue that one of the best ways to achieve good governance is to have “skin in the game.” When he joined the board of Sunbeam, he had to put up $100,000. When I got on my first board it was a NASDAQ-listed financial services company in New Jersey I had to put up $10,000, and that was 20 years ago.

So it's important to have skin in the game. And, frankly, I would rather have significant investors on the board. I'm not as concerned about independence as other people are. You would expect that shareholders would not only bring fiduciary responsibility and experience, and have a true understanding of the industry, but they also would put out cash and have that cash at risk.

I had an opportunity to testify before Congress in March 2002 and they asked me to spend 15 minutes giving a primer to members of Congress about corporate governance. And then six and a half hours later the chairman got up and said, "Will somebody please tell me how a board can fulfill their fiduciary responsibilities by only attending five meetings? And somebody tell me about the role of integrity.” We were asked to make a report to Congress. And Congress not only looked at it in their deliberations on Sarbanes-Oxley but also the stock exchanges looked at it.

We track the number of hours directors spend in board related issues. We
started tracking that when I first came in as CEO of the National Association of Corporate Directors in 1999 and then the average was like 100 to 125 hours a year in board-related meetings, conference calls, reading materials, committee work, and so on. Now it's over 150 hours.

But, frankly, more time is not equivalent to getting improved fiduciary performance—or improved oversight. The reality is our members are being killed by information. I was able to spend time with Bob Herman when he was SEC accountant. He said, "Raber, you are going to have to spend more time on disclosure, and it's full disclosure and early disclosure." I said to him, "That's fine, but believe me if somebody, a CEO or a member of management, or an outside auditor wants to keep information from you, they will keep information from you."

There has to be a climate of disclosure, and the focus of that should not be "when in doubt give the board a bundle of information." We're seeing board books coming in at about 400 pages. I was giving a program last week for a board retreat of a public NYSE-listed company, and the first thing the CEO said to me was, "Boy, if you want to suck out the energy from a director, give them all the information."

We have a partnership with the American Corporate Counsel Association. I said, "We look to management, and specifically to the general counsel and corporate secretary. It's up to them to give us the right information." Everybody is scared so they want to give you everything when in doubt; even though you have this big board book they keep feeding you more information right up to the time of the board meeting.

Frankly, if you want people to walk away from corporate boards, overwhelming them with information is the way to achieve that. Your responsibility as management is to make sure they get the right information; you can always put something on the website or give directions to access to the database at the company to get more research if they want.

A comment about the importance of knowing the industry. I can't imagine anybody going on to a board unless they had a strong, in-depth understanding of the industry. A lot of people disagree with me. They'll say, "I'll go for oversight and leadership and we can pick up the information on the industry." Yeah, that could happen. If you want somebody to bring value in special areas, such as commodities pricing or technology marketing, that person still has to understand the industry. When people ask me, "What should we be doing in education?" I say "Put aside governance education. You need your direct reports filling you in, direct reports to the CEO, on what is happening with this particular company."

So you have industry issues, you have information issues. But more of the questions we get these days are on independence and, frankly, we’re hearing similar questions from companies that aren’t even listed on any of the exchanges. The rules are no family members, no business with the firm, no financial relationship beyond director fees. We’re saying they should make an investment. But the real question should be, are they independent minded?

You are going to see more people beating the independence test by going
from a majority-owner to a substantial (but non-majority) position. I think in that way the reforms have made a difference. But at the end of the day there are a lot of directors who are passive directors, who cater to the decisions or recommendations of the CEO; they are not engaged. It really hit me when the chairman of the committee that I testified before said, "Now, tell me what integrity is." I used to think I knew what integrity meant. It meant people of stature, people you could trust, people who enjoy the respect of their communities. It is the courage to get up and ask the tough questions when you see the red flags that we were talking about. Which brings us back to your question, Margaret: There is a clear expectation as a board member that you need to be engaged, you need to ask the tough questions, you need to say, "I'm not going to leave this room until you clarify to me what this issue regarding this off-balance sheet transaction is all about."

So the reality here is that you need not only the right information, you need to have independent-minded directors. And the other issue is financial. If we look at the area where we get the most effect insofar as helping us understand our position, it is a better understanding of finance and accounting. And I can't imagine a person coming on a corporate board who doesn't have that industry experience and that financial background.

PROFESSOR BLAIR: That's a daunting challenge. Let's talk some more about this word "independence" and its implications. The SEC has now approved the new New York Stock Exchange and the NASDAQ rules. According to the Wall Street Journal, the improved rules require that "A director who has declared independence can't be employed at the company or have worked there within a prior three-year period, nor can any of the director's family members." There are also restrictions on how much money directors can receive from the company, other than for board service. NASDAQ limits annual payments to $60,000 and New York Stock Exchange limits such payments to $100,000 a year.

What does this say about what we mean by “independence?” Independent from what, from whom, and for what reason? I mean, there is actually almost no empirical evidence that companies that have boards that are dominated by “independent” directors (usually meaning only that they are not currently part of management) perform better than companies that have insider boards.

I just want to hear a few words from everybody on the panel about where we are going with this idea of independence? You now have a checklist of things that are required for independence, but what does it really mean? Claudine?

MS. MALONE: I think there is some evidence with regard to family members. If you think about Rite-Aid, for example, and there are a couple of others in the communications area where you have had members of the family on the same board of a public company and there has been collusion and fraud. They have been tried and convicted now, so I believe that is correct. With regard to consulting fees, for example, directors in the past have sometimes received $60,000 or more, and directors at NYSE companies have received $100,000 or more in consulting fees over and above their board fees. And in these situations, it can make you somewhat less willing to be aggressive with management in an open forum. Years ago I did this for one company, I decided I would never do it again because I got to know
members of middle management much better than I would have otherwise. And I thought that was probably not appropriate.

PROFESSOR BLAIR: You did consulting?

MS. MALONE: I did consulting at a company on whose board I served. I taught an in-house executive program over a two-year period and I got to know those middle managers extremely well. And I decided before Sarbanes-Oxley that that probably wasn't an appropriate relationship as a director and I decided I would not consult for any of my companies because I thought I was only human and I would therefore be more biased toward the managers I knew and less willing to challenge them if they came to make presentations or things like that. This seems like common sense, but if you haven't experienced it you might not fully grasp the problem.

So I was actually disappointed that the SEC backed away from no fees (other than director fees) and allow outside income. I saw no reason to back away. I don't know where the pressure came from.

MR. ROSENBERG: One of the companies I sit on has publicly traded bonds, but not a publicly traded equity, and a rather green CEO. And after being 35 years in an industry I basically helped him for a consulting fee that was a fraction, maybe 5 percent of what it would have cost BCG or McKenzie to do a strategic plan, a plan that was extraordinarily well received by the board. So my life experience is that some of these rules get in the way of just good management and sound practice. And I think anything slavishly adhered to like that can get in the way of performance.

DR. RABER: You look at the title of this program, "Restoring Trust in America's Business Institutions." We have 15,000 members and clients, 85 percent of whom are sitting directors, and the reality is they have lost that trust. Whether you call it corporate McCarthyism or whatever, the reality is these days when somebody hears about a debacle or fraud or malfeasances, they ask, "Well, where was the board?"

Years ago the general public wouldn't know the board members. Even at the largest companies they would have no sense of who is on that particular board. Now they know who is on the board and there is an immediate reaction to any conflicts of interest. I agree with Claudine that it should go beyond some arbitrary definition such as not having worked for the company for three to five years. And it even goes beyond real conflict of interest. Perceived conflict–anything that would give even the impression that you're not looking out for the best interest of shareholders and customers and employees, that somehow something is in it for you–is also a problem.

I happen to believe it also goes well beyond Sarbanes-Oxley and exchanges. It has to do with those principles we talked about: independent mindedness, accountability, and informed judgment. You know you have to have people on the board who are fully concerned about the people with investments in the particular company. The mind set is what matters.

The Corporate Library tracks individual directors. People who are on
governance committees looking at people being considered to be nominated for board positions can go right to TheCorporateLibrary.com to find out about the pitfalls or the problems or the history of a particular director. When something happens we will get a call saying, “What happened there?” My first instinct is then to ask what’s wrong with a particular director. So, again, it goes beyond the rules.

PROFESSOR HAFT: I agree with Judge Strine that substantial stockholdings are a good thing, providing you meet the other criteria of independence. Stockholdings should make you a perfect candidate because you have an economic stake in the company and the real incentive. Under Sarbanes-Oxley and heightened liability, we are going to have a problem creating incentives for good people to go on boards. Such incentives would be provided by a substantial equity stake in the company, and also having indemnity and insurance protection and substantial compensation.

Now, independence, as I conceive of it, primarily means being independent of senior management. We want a truly independent second view of whatever the issues are, be they financial presentation or transactions. And, secondly, independence means that in a conflict of interest sense the director not have transactions with the company or financial stakes in customers or suppliers.

Then the last point: Besides the appearance of independence, independence under my criteria or the New York Stock Exchange’s criteria, you really have to have guts and face up to senior management. This has been said before. In 1997, the Business Roundtable said regarding independent directors: "If they do not have the personal stature and self-confidence to stand up to the CEO, they’re not independent." It is hard for a nominating committee to screen for these personality characteristics, but I think they have to. According to the standard literature, social ties, a desire to be a team player, or simple passivity, can compromise a director’s independence. You may not be getting a good director no matter whether they meet every other standard that exists.

The last point is that the people who are going to have to pick these kinds of directors in the future, certainly under the New York Stock Exchange standard and evolving state of the art, will be a nominating committee composed of independent directors themselves. As Judge Strine says, the thing we can't ultimately solve now is to have true corporate democracy in the sense that the nominating committee is going to have people who are sufficiently independent, really independent in the sense that I said, and that they replicate themselves as they bring others onto the board, rather than the old pattern of choosing whoever the was selected by senior manager.

JUDGE STRINE: I think this idea of director independence has just run riotously free of any kind of rational constraint. And what I mean by this is that there were some elements of old-fashioned boards, which were not the worst thing in the world. The idea that a company in a community had some generational strength and that it was larger in some senses than the current CEO and that the board would comprise the top two or three managers, and maybe the company's banker, and maybe even the company's lawyer. Some elements of that are good if you actually believe that the boardroom should be a discussion of business issues.
One of the real problems, I think, with the Sarbanes-Oxley reforms is that all the functions now that have to be done entirely by so-called independent directors. Most of the scholarship suggests that independent directors have some utility. There is probably some utility to having some insiders in, people who do have more of a stake in the room. But you need to have a majority of independent directors just to perform the functions of this new law, unless you want a board of 23, you have the governance committee you have to staff, you have the audit committee, you have the nominating committee, and you have the compensation committee, and all are all supposed to be composed of independent directors.

We already talked about the fact that the audit committee has too much to do. In fact, you probably need to divide its functions, especially the compliance functions, where you really need independence. Because when we think about independence, we are talking about independence from management.

I truly believe that, with most decisions that come before corporate boards, the CEO is fully independent in the sense of being able to capably act in an impartial basis in the best interest of the corporation. There are situations, such as entering into arms length supply contracts, where the CEO has no rational reason, any different from any other board member, not to act in good faith.

One of the problems I see is this labeling of people. For example, if you are an “affiliated” person, say, you own 11 percent, then you can't serve on the audit committee. Now, do we think our friends in the plaintiff's bar are just going to say, "Oh, that's only for the purpose of audit committee" when they write their briefs? No. And I understand some of our wonderful friends in the corporate governance community are picking up with that definition and coming up with their own labels, saying if you have that kind of equity participation they don't really consider you an independent director for any purpose.

Delaware law is contextual about this. We tend to look at the question of independence and conflicts based on the decision that's before a board. But what we now have is blanket labels to apply to people. You have all heard that the real challenge is where are we going to get these people. So one of these thing we need to do is expand the pool. Not everybody on a board can be a current CEO. But if you run one of Dupont's business divisions, you are running a pretty damn big entity. You could probably serve on a public company board.

I read Directors and other board magazines. I saw Tommy Lasorda was added to the board of Lone Star Steakhouse. I have no problem with Tommy Lasorda, but he had been retired as a manager because he no longer knew when to send in the runner. He is now on the board. I can see having Tommy Lasorda on retainer and to go around and pump up the sales staff. But why in God's name is Tommy Lasorda being added to a board? And is it a divine right of every former United States senator to serve on a Fortune 100 company board? They are often on five or six of them.

One of the many good things about diversifying is that public company boards went out and looked somewhat deeper in the managerial ranks and the professional ranks for minority and women directors. I think we need to do that
across the board. Someone running a business division might well be a great director on a mid-cap company in his community or her community. And I think we are also going to have to expand the pool of people serving as directors so people can be on a smaller number of boards, and so they develop some affinity and bring some expertise. And that is going to require a whole new approach to populating these boards.

PROFESSOR BLAIR: I want to come back to the question of where we are going to find these people. But before we drop the question of independence, I have a suggestion for a litmus test: Are boards of directors going to do something, and do they need to do something about CEO pay? Can they confront CEOs and get CEO pay in line? Is that going to happen? And what is it going to take to get that to happen? Do you agree with me that CEO pay has been out of line? Who wants to pick that up and run with it? Roger?

DR. RABER: Well, the Achilles heel of corporate boards is the fact that executive compensation is broken, and we have done an awful job with shareholder-board communication. Just look at what is out there regarding the SEC and accessing the proxy by shareholders. If we did a better job in being alert and answered questions at annual meetings and had some sort of process in place whereby investors can communicate with directors, we would be well on our way. That is a big issue, but by far the most egregious practice is just excessive compensation with really no relationship to long-term performance, no appropriate metric, no attention to a sense of fairness. If we don't get our hands around that, if corporate boards and management and the corporate governance community fail to do this, I think the legislatures will do something. And that scares me.

People ask, "How long is this corporate governance thing going to ride? Are we going to have to worry about this for another couple of years?" And people say, "No, it will pass." The reality is it's going to go on. It's going to stay on the front pages of the major dailies and it is going to continue to focus on excessive compensation for executives.

MR. ROSENBERG: Part of it is the system itself that creates the problem. Basically the management hires Towers Perrin or some similar firm, which does a competitive survey. And generally speaking because the firm wants to get retained again, it is very rare that they say that the CEO is overpaid. They will find a quartile and tell the client that the CEO should be in the top of it. Everybody wants to pay for superior performance in the top quartile of the range. Because everybody wants to be in the top quartile, there is a natural escalation process and that really forms most of the system that is in effect for most corporations. They use outside consultants, they do comparative studies, and it just escalates.

There are other forms that are emerging, like value-added, and other ways to evaluate the management team and its compensation.

JUDGE STRINE: What about actually acting like you are the boss of management? The worst jury for any defendant in any of these corporate scandals would be to find 12 executives who make around a $125,000 a year and put them on a jury for any of these things and watch what they think. Because they've gotten a
letter every year, saying "Oh, we're downsizing. Guess what, you're sharing your secretary with four other people. Guess what, mergers of equals means twice as much top management, half as much middle management. No raises this year." And then they see the CEO comp package.

It's a simple question. If I were a middle manager and went in to my boss and I said, "You know, I had a great year. I would like a 30 percent raise," they would say, "Leo, you know, this year we are giving out an average raise of three percent. You might get five, fine. But, you know, we also have a really good health plan and it has five counseling sessions available for anyone if you're unhappy about this."

But what do they do? You have got companies where it is the son of the founder who is the CEO and they act like he is A Rod and they've got to pay huge amounts of money to retain him. But where is he going to go? Is he retaining himself? It comes down to courage and attitude. Does the board believe it's the boss of management for this purpose? I believe boards of directors should primarily be composed of people who ought to be able to be an effective negotiating force with the CEO. And if they're not, that's really scary too. Because if you can't actually negotiate the top officer's pay using the outside advisors to provide a way to get you to act like a market participant, then God help us if we are relying on you to do other things. I think this is really a breakdown and it is an insight into the culture.

We're talking about restoring public confidence. You're not going to gain the confidence of the employees in your organization with unreasonable compensation for top executives. They're the ones who are getting cynical, they're not motivated. They see this stuff.

PROFESSOR BLAIR: So the first thing we do is shoot all the consultants—is that right?

DR. RABER: You hire a consultant that reports directly to the compensation committee and does no work for the rest of the company. That's the first step.

JUDGE STRINE: There are a lot of CEOs you would want to retain. But in most employee retention decisions you are trying to figure out what you have to pay to keep them reasonably happy and no more than that because you are trying to make a return for your investors. Who do you hire when you negotiate with the AFL-CIO? Do you hire Towers Perrin to negotiate with the union? No, when you negotiate with your collective bargaining units you hire somebody to get you the best deal.

And who even understands most of these CEO packages? They may have five or six components. Look at the NYSE board and the packages awarded to Mr. Grasso. It wasn't even so much the level of compensation, but that the board had no idea—they came out and publicly said they have no idea what they were paying. That does not instill trust.

PROFESSOR HAFT: I'm beginning to feel like I'm the business person and I have got idealists around here. We are setting ideal standards, which are not going to be met.
The latest state of the art is the recently adopted New York Stock Exchange governance rules. What do they do? They say that the independent directors of the compensation committee will, in essence, set the compensation. Now, if we combine that with what Roger and a lot of us believe, which is that you ought to have knowledgeable CEOs as independent directors, we then get to what the Delaware Supreme Court once said: "There but for the grace of God go I." That is, you are asking CEOs to fix some other CEO's salary. Now, if you start with that dynamic, it seems to me you have to ask where these hard-hitting CEOs of other companies are going to come from? They're going to be from other Fortune 500 companies, which means they are sitting on each other’s boards. And, guess what, they are going to be on the compensation committees. So we are going to start, as it is now, with these high salaries set under this supposedly perfect “good governance" standard.

I'm not suggesting that it’s the job of the Delaware courts to solve this problem by looking at some of these overblown packages under corporate waste standards. There are other ways, besides the courts, to do something. But right now we are talking about aspirational things when we say we ought to be tough in negotiating.

PROFESSOR BLAIR: Claudine, is there something practical we can do to rein in executive compensation packages?

MS. MALONE: I do agree completely with Robert that if you allow it the compensation consultants will come in working for management. And they always want to ratchet up management's compensation. The offset is a compensation committee that can hire its own consultants and can apply common sense. There is really no prohibition against common sense being used by a board in tying compensation to performance.

There’s another side of this also. While there have been many egregious examples, we do occasionally fire CEOs. When they don't perform they can get fired and do get fired. But that brings up another aspect of the problem: the severance packages. Here again, common sense can be applied. It depends on the terms on which you contracted at the beginning. If you go out to hire someone, asking them to give up their 10-year or 15-year track record of success at another company where they have all kinds of stock options and stock, vested, or unvested, which they're giving up, you have to give them a contract that will enable them to come. But, given a lack of performance and the benefit of hindsight, these packages can turn out to be embarrassing. On the other hand, if the executive performs well, he or she will have earned the package.

So it comes down to a question of judgment. Some of the mechanisms for imposing constraints, particularly Section 162(m), the IRS code section that lays down the criteria for being able to deduct compensation in excess of a million dollars, have been in place for many years, and many companies have implemented them.

PROFESSOR BLAIR: And are people using them with common sense, though, Claudine?
MS. MALONE: Well, common sense does help.

DR. RABER: Judge Strine, isn't there a duty of care issue here? Suppose an executive receives compensation that is just beyond anybody's expectations, with very little connection to shareholder value or company performance. A director says at the end of the day, "I didn't realize the impact and I didn't understand the final numbers." And if that director is the chair of the compensation committee—even though the business judgement rule said you will protect us in many areas, isn't this getting toward the edge of where there is some reason for concern by the courts?

JUDGE STRINE: Here is the way I like to talk about this: If you are conscious that you're not fulfilling your duty of care, you don't have a negligence problem; you have a loyalty problem. If you know you're not doing your job, that is a culpable state of mind and there is a job to be done. And if you put yourself in that position—that is basically what the recent Disney decision said— if the plaintiff presents facts showing you knew what your job was and you knew you weren't doing your job, that takes you out of this realm of care into something else.

People on boards should not put themselves in that position. It is very hard for the plaintiff to ultimately prove that you breached your duty of care if you are counseled by good advisors. That is where the 400-page board book, and having a bunch of consultants, helps. It's different when you have people telling the Wall Street Journal, "I just didn't really know that this cost 60 million bucks." If you were general manager of a sports team and you did that, you wouldn't want to listen to talk radio when you're in town.

PROFESSOR HAFT: Just one quick comment on the 400-page book. I always think, as a litigator, that it's terrible to have a 400-page book with all the details you are supposed to know spelled out. That's just inviting plaintiffs with 20/20 hindsight to get it and if it is 400 pages there is going to be something in there that didn't turn out the way the manager said. It is crazy to have that.

PROFESSOR BLAIR: I want to ask one more question and then turn to questions from the audience. The issue was raised of where are we going to get these people. And I believe it was Leo who said something about ancient history when corporations were rooted in a community and the board sought respected members of the community. Maybe they were the bankers, maybe they were senior people who served at the top level of other corporations in that community. The Conference Board Commission on Public Trust and Private Enterprise recently published a very good report. It said that, "managing for stock price gains too often means managing for the short term. While managing with an eye toward long-term operating performance is in the best long-term interest of the corporation and its shareholders as well as its other constituencies, such as employees, communities, and customers."

Where are we going to find directors who meet all these independent standards and all of these abilities to process all this information but have the capacity also to think long term, to understand this company as part of the world community, if you will, and take on these tasks? Are they out there and we are just not finding them? Or is this too high a standard and we're not going to be able to find them?

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DR. RABER: It's an interesting question. We have a resource called the Director's Registry at NACD. When somebody's looking for a board position, they fill out material and send it to us, and it's open to any company that would be interested. Yet our members call up and frequently people will say, "I can't find a director." First of all, if it is the CEO calling up I have some concerns. Or maybe they have retained an outside search firm or maybe it's the chair of the governance committee who is calling. But that aside, I say, "Well, tell me your criteria. What are the criteria?"

"Well, it has to be a sitting CEO." Believe me, you are seeing fewer sitting CEOs sitting on multiple boards. One other board is the maximum. I'd be concerned about the CEO serving on two other boards. While I think it is important for CEOs to sit on the other side of the table, not all independent directors can be other CEOs.

Are there fiduciaries out there who will bring oversight and can bring value beyond oversight, who have experience dealing with crises, or who have run major divisions of large companies, or who have been CEOs or CFOs of privately held companies or nationally recognized large nonprofits like the American Red Cross or Public Broadcasting System? There are individuals out there who will be able to provide that oversight, and have that expertise. You are going to see CFOs, general counsel, chief information officers, and people who may not be the more traditional profile, but who will meet, I think, the taste test of the rules we have as a result of these corporate reforms as well as a principle-based integrity test.

MR. ROSENBERG: I think that may be a downside to some of the new rules. Because if we get flooded with lots of accountants on boards, I think that companies will not benefit, necessarily.

DR. RABER: You mean like retired partners of accounting firms who obviously are not providing accounting services to your company?

MR. ROSENBERG: Unless it is a real need of the company. I can see it where it might be a good thing if a company has a marketing need and finds a director from a marketing company. But oftentimes a lot of the benefit comes from directors having a real relationship, an open relationship with the CEO, where the CEO can feel free and open to talk and get counsel from people who have had similar experiences. If that starts to break down, or if the boards get too large and too unwieldy and there are too many specialists, I think no one will be well-served. Compliance will be maintained, but I don't think that's an end unto its own.

I'm not sure there really is an inadequate supply of directors. I don't hear of companies going without directors. I think that one of the important things is for nomination committees to think thoroughly through what the assignment is and what it takes to fill the assignment, as opposed to getting a prestigious name or someone out of public office or some other person in some capacity that will add window dressing to the board, but not necessarily add real value in terms of governance for the corporation.

DR. RABER: When a CEO first asked me, would you like to serve on the
board, there was an evaluation process before I joined. But the CEO really was thinking "I want this particular person."

What I see, and I see it as a positive development, is more focus on the governance committee on coming up with criteria: “I am sure there are debates and you and I may disagree on certain things. But let's come up with what we think would be a good profile of the director that we would like to nominate." I think that's good where the choice is based more on predetermined criteria rather than "I know you, and we play golf every week, so I can get you in as an independent director." I think those days are gone forever. You have these directors now looking at criteria and then trying to find somebody that meets that particular qualification.

PROFESSOR BLAIR: Claudine, if you have anything you want to add on this I would like to hear your input and then we will go to the audience.

MS. MALONE: I agree that for several years now the boards and the governance committees have been trying to identify needs and look for replacements. I’m on a board right now where we are going to lose a really top notch economist who knows the industry extremely well. Now, Robert might think that is a specialist. This is an experienced director who is very independent, very knowledgeable, and willing to speak up. It is really a hard vacancy to fill. We have really talked about that openly, trying to find a person.

But my own personal view is that it's a team. You don't have a team of all point guards. You need to have various positions filled there. On the audit committee now, at least one member has to be a financial expert. If you have an industry that is very competitive, is global, you might want an economist.

Although I don't like to say this in this environment, one of the unfortunate developments is that it is very much more difficult now to get lawyers to serve. If they're actively in practice, and their firm is providing services to the corporation, they are disqualified. And I found that having really independent thinking lawyers on the board can be very helpful to the board.

So it really is a question of, again, a little common sense, of being diligent, being independent and trying to have a team that can really work well together.

PROFESSOR DALLAS: I was thinking about Judge Strine's statements that, in fact, having an executive of a business division might make a lot of sense on a particular board. But also he said that any member of the board should be able to negotiate CEO compensation. Of course an executive in a corporation, a lower level executive, would not be in a position to do that. Now, these two statements on their face seem inconsistent. I think that in essence, it points out an important fact, which is that there are two main functions that we want the board to perform. One is the oversight function. And there certainly we want to have independent directors negotiating on CEO compensation. On the other hand there are values beyond oversight that are also important. Therefore we want executives of business divisions on the board of directors as well. But that leaves us in a quandary, doesn't it? If you have an insider-dominated board, that gives value beyond oversight, but in that situation you have the problem in terms of your oversight. On the other hand
if you have an independent board, a board that is dominated by independent directors, you may be performing oversight functions quite well, but you are not also getting at these other values that board members can perform. They can provide certain kinds of services and information to the board. In fact, there is a study that shows that if you have either an insider-dominated board or an outsider-dominated board, actually either one is better than any other kind of board. I think the reason is that there are two different functions that we're talking about, both of which are very valuable.

So the question is, I think, how we should restructure boards so that we can get both of these functions from the board of directors? Just as we have divisions and departments in a corporation, maybe it's time we look at a board and not think of it in terms of a single board, but a multiple board, in other words, possibly a dual board. One board that performs the oversight function, another board that provides other kinds of functions that we expect boards to perform, where the executive of a business division should possibly be on that board, a banker or lawyer or something to that effect.

PROFESSOR BLAIR: That is very provocative, Lynne. I want to have time for the panel to respond.

JUDGE STRINE: I think I just want to be clear about what I said before. I was saying in terms of getting independent directors, that someone at a very big company, a Fortune 100 company, who is running a business line is probably running a business unit that is bigger than a lot of mid cap/small cap companies. And I think getting their expertise in the smaller companies can be very valuable. There are peer issues, of course. And I think you have large cap companies where in order to stand up to the CEO who thinks he is king of the world and bestrides the universe, you need comparable Titans.

But I think your point is a good one, which is, are we moving toward the pure monitoring board in America, where the board really is a compliance mechanism, rather than any kind of forum for business decision making? I think Sarbanes-Oxley moves us a lot more toward that model because it imposes so many monitoring type functions that it makes it difficult to comprise a balanced board with, say, four insiders or four people who would not be independent and five outsiders, because the five outsiders can't, frankly, fulfill all the functions that are being mandated.

MR. ROSENBERG: I think when we talk about a balanced board, what is playing back to me is you can get all the benefit of senior management at a board meeting without having them become members of the board. And the kind of vision that I think may make sense is a balanced board, one that has people, all of whom are independent but some of whom can do oversight work, some of whom work within the industry who also can provide strategic counsel to the CEO and to the rest of the board, and specialists in cases where it is required, like the economist that may be required in certain companies.

I think you can accomplish all that. I wouldn't advocate to have a board of half insiders. I think you can get all the benefits of the insider without having senior managers sit on the board.

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PROFESSOR HAFT: I'm a little wary of any quick structural solution, like splitting the boards. You know they have a dual system in Germany. It is not working particularly well there with the monitoring board on the top and the operating one down below. The other thing is I think the current system or the one that we're going to continue having, with a majority of independent directors and a minority of insiders who know the business who get together regularly and pool the information at meetings, plus the independent directors as monitors and negotiators in setting compensation is a good system, if we are talking just structure.

PROFESSOR BAUMAN: I have a couple of mundane questions, but I’ll tie them together under the question of who's going to be on the board. As a factual matter, what has happened to director's fees as a result of Sarbanes-Oxley? And what's happened to director's and officer's liability insurance? Is it harder to get? Is it more expensive? What are the costs here as a result of the new system?

DR. RABER: We have tracked director fees. They have gone up about 20 percent since Sarbanes-Oxley. And people ask, "Well, are they overpaid or underpaid?" If they're doing a good job, you can't pay them enough; if they're doing a lousy job, they shouldn't get paid anything. We see compensation for committee chairs going up as well.

My concern there is that even though board members are spending more time, it is a misconception that the extra time is what is driving the increase in board pay. The real driving force may be that there is more liability. Go back to what Claudine said. I know the board is insured and if they're sued it will be in their capacity as members of the board. I have sat next to people from AON and Marsh & McLennan as insurance brokers who say, "We insure the board." But then you have the litigators on the other side saying, "We are going after the chair of the audit committee." So the concern is on the greater exposure to liability. I always say to folks that one of the first things you do when you think about going on a board, is, in addition to checking all the things we just talked about in the last hour and a half, you should also look at the D&O policy. You should always look for what is excluded. When I was on a bank board that was heavily regulated, the exclusion was regulatory matters.

So I think you're seeing perhaps less coverage but paying more. We see Chubb and AIG are trying to find some umbrella packages where, for individual directors who sit on multiple boards as independent directors, there would be a package for that person over and beyond the regular coverage, or a package for the entire board of independent directors.

That liability issue probably is one of the biggest fears people have about whether they want to go on a particular board.

PROFESSOR HAFT: Especially when the “out” for the insurance company is fraud, since every suit that is brought against a director claims fraud.

PROFESSOR STOUT: It actually strikes me as a little bit odd that in the wake of Enron, Rite-Aid, and WorldCom, there is all this focus on the role of directors as a means of preventing those sorts of debacles. And it seems to me that
there are really two monitoring functions that we have mentioned that independent directors can perform. One is to police against interested transactions. And I think that boards perform a very important role in that regard. I think, by the way, they performed that role for 30 years. We didn't need Sarbanes-Oxley to have a corporate law rule that said that "Interested transactions are subject to judicial scrutiny, unless they are approved by the independent members of the board." When it comes to interested transactions, I have one subquestion, which is, do you actually think this is a new problem or even a particularly bad problem? I don't have the sense that corporations are out there approving interested transactions more often than they were before.

But now we get to the second monitoring function that we are talking about boards performing, and that is the function of overseeing compliance. I can't avoid the suspicion that there is probably no board that we could think of that necessarily would have prevented the Enron implosion. It is true that after the fact, you can point fingers, but—and I would be interested in your reactions—is it really fair to say, A) that independent directors were responsible or even, B) they're our first line of defense?

As a securities regulation professor, I'll offer an alternative hypothesis, which is that between the Congress and the '95 Act and the '98 Act and the Supreme Court and the Central Bank case, we basically gutted civil liability for fraud and particularly accountant's liability with rather predictable consequences that couldn't necessarily be prevented by board directors, independent or otherwise. So that's probably enough to chew on for now.

MR. ROSENBERG: I think the boards have a huge role to play in strategy, in structure, and in tone and trust in the management. And I don't know if it is the Judge or someone else who asked a very simple question: "How does this company make money?" And I suspect had anybody asked that question at Enron, and asked someone to explain the derivatives, then it's not hard to conclude that the board could have done a much better job in terms of digging in and insisting on answers.

Managing a business sometimes is like sailing; there are long moments of calm, punctuated by moments of sheer terror when you have to tack. And when you go to a new business and you develop a new activity like the SPEs—Enron's “special purpose entities”—or anything like that, it is a red flag signaling that the board should move from, let's say, engaged to hyper-engaged.

There are times that require a higher level of engagement. Governance committees have to think through and ask: What does the company require at this moment in time? How should we behave at this moment in time? When is it time for us to engage? Many times it is not appropriate for the board to try to operate the company. But there are times, times of huge crisis within you have to do that.

So I think that a board can be super vigilant, can think a lot about what its responsibilities are, where the company is, what its requirements are, and act together. That is why I think a lead director who is worrying a lot about board performance could, in fact, have raised those kinds of questions as this company moved massively into a brand new activity never done before.
Some people I talked to about Enron said, "Derivatives? No one makes money in derivatives. Who would ever be in the derivative business? It is a zero sum game." On its face it raises questions even among rank amateurs, and I know nothing about that. But at least it would have raised the question had it been observant directors doing their directors’ jobs.

JUDGE STRINE: I think Enron is an interesting example because it may be an example of following corporate governance rules rote, leading the board into being supine. What I mean by that is, I think they came in and got a presentation about the 3 percent rule (the accounting rule that permitted a company to treat transactions with special purpose entities as arms-length transactions) and then moved on to whether Skilling could date a subordinate. That audit committee didn't ask about the fundamental economics of the transactions, which amounted to hedging with themselves. In the Brazilian power company investment they funded an SPE with the stock of the same investment whose gain they were trying to hedge! Even I can get the stupidity of that and I'm no Warren Buffet.

But one of the most effective things that Sarbanes-Oxley did at the managerial level is this heightened certification requirement by management. Because the senior managers are now getting all these sub-certifications from down in the rank and file. And there are a lot of costs that are attached to that process—I'm sure there are more outside advisors being brought in. But it is making people feel ownership and feel responsible.

So there were some things accomplished at the managerial level. And I think one of the things that managers need to do is to design good compliance systems. It's not the outside director’s job to do that, but it is their job to make sure it gets done. For example, earlier, at the auditing panel, someone said it's not the auditor's job to detect fraud. Well, you know, auditors do have forensics capabilities at their firms. Managers should make sure that they are doing some forensic auditing periodically. It seems to me that is a good part of a compliance system. So I think outside directors do have the capability, especially if you comprise the board correctly, to make sure that they have got systems in place, and to ask hard questions regularly so that they do act as a check on management.

MS. MALONE: There were many things at Enron of which I, as a director, would not necessarily have been aware. But when a board votes three times to suspend the Code of Conduct I really do think that should get your attention, even if you don't know what it's about. If you put the Code of Conduct in the first time or you had it in effect and you suspend it so the CFO can engage in what looks like a self-dealing activity, I think that is suspicious.

From the audit committee's point of view on derivatives--I have decided I have a rule. And I think it's useful to have some courage here. My rule is, if I have done my homework and it has been explained to me the first time and I don't understand it, shame on me. If I do some more homework and you explain it to me and I still don't understand it, shame on you. I feel that with a financial background and an adequate explanation I should be able to have some idea of how we make money on the deal.
I have tried to apply my rule. And a couple of times it has really worked. There are probably 20 other times I don't know about that it hasn't really worked, however.

I wanted to say one other thing about the 400-page book that you get before the meetings. The Seventeenth Century mathematician Blaise Pascal said, "I apologize for not taking the time to make this letter shorter." I don't want 400 pages! I want an executive summary that leads me to the appendices so that I can go and find the information. If someone wants to give me an hour presentation with no time for questions, or a 400-page book that I'm supposed to look at, that does not pass the smell test.

DR. RABER: Just to give a quick example, Lockheed Martin is a huge corporation. Gwen King is a director of NACD and she was chair of the audit committee for years. She did an exceptional job. She learned through experience and classes and she had this duty of curiosity. She would say, "I don't understand what you're talking about. And I have plenty of time. We'll just sit around. I want to make sure if I understand, and if I think the shareholders will understand." And she would just say, "I don't care how long it takes."

You're right about the red flags and about the Code of Ethics. Why wasn't somebody saying, "We just can't do that. It's an oxymoron to suspend the Code of Ethics." Even though they may not have understood the partnership and off-balance sheet stuff, they should have said, "Hey, there's a red flag."

PROFESSOR SUNDER: I have two questions.

In the governance literature of the last at least 15 to 20 years and certainly post-Enron, there has been a lot of emphasis on independent directorships so directors would not have the incentive to serve the interests of management. What I would like to know is how does the independent director solution provide an affirmative incentive to the directors to pursue the interests of the small shareholders, the minority shareholders who are not there?

Second, I know there is a lot of concern about liability of directors that may prevent the qualified candidates from agreeing to be the directors. But in the absence of liability or in the presence of insurance, what incentive exactly do they have to do what they're supposed to do?

PROFESSOR HAFT: The substantial stock ownership point that Judge Strine pushed and that I advocated is that directors should have real economic interests at stake. This could be in the form of stock options for the directors, and certainly increased pay. I don't see how you get anybody who is competent and would stand up to management to be on the audit committee, unless they are substantially paid and have full D&O coverage and even some other coverage which goes on top of it, which insurance companies have developed for particular directors that they know are good risks because they know all about these persons as individuals. And you have indemnity. You have to have the pay and ownership stake, and I think then you have real incentives.
JUDGE STRINE: Look, there are some people who make a lot of money being on boards. Whether that is a good thing or a bad thing is something we can all debate. There are people who make well over a half million dollars to a million and a half a year just serving on boards and probably too many of them. Many people serve on boards because it is an interesting sideline to what they do. They find it challenging and rewarding work and they have a feeling of trusteeship about an institution that employs people, and that's important to a community and they try to do the right thing.

I don't believe there is a mechanical, homo-economicus basis to human nature. It's not true or you wouldn't be a professor at Yale because you could make a lot more money doing something else.

DR. RABER: There are some red flags out there in choosing directors. If somebody says, "I want to get on a board," and I say, "Why?" and they say, "First of all, tell me how many meetings do I have to attend and how much are you going to pay me?" that's a red flag. On the other hand, they may feel they can bring value. "Hey, I'm in a position right now, not only where I can provide oversight, but where I can also bring value to the company." So you can find out pretty quickly if this person will truly be the fiduciary you're looking for.

PROFESSOR BLAIR: On balance, with all the costs that are going to be imposed on corporations by the regulatory changes of Sarbanes-Oxley and the stock exchange rules and the benefits that will flow from those new rules in terms of heightened information, heightened awareness, heightened monitoring capability, what is the cost benefit trade off? Is it positive or negative?

MS. MALONE: Costs are identifiable, the benefits are yet to come. On balance I think corporate America brought it on itself. And I hope we can manage to get the benefits once we get through all the costs. So it is down the road for the benefits, I think. There are some things I am much more enthusiastic about than others. If you say to me I have to say yes or no, I'll say yes, reluctantly.

MR. ROSENBERG: I think that is a good answer. My first reaction is that the costs outweigh the benefits and there are unintended consequences that I see that are not going to properly serve companies and all of their constituents.

DR. RABER: It's clear to me that the Sarbanes-Oxley and other corporate reforms are not going to be what restores the public trust. It's going to take a lot more than that. I think companies that are used to being regulated, like financial institutions, may find it a lot easier to deal with the rules. In the end it adds a certain amount of fear, a certain amount of vigilance we haven't seen before, but we sure hope that we get beyond that, because otherwise we're in for a long ordeal with executive compensation, shareholder communications, and so on.

PROFESSOR HAFT: I agree with what Roger said. I just add that on the benefits side, they have been exaggerated. A lot of these things are not going to occur as claimed by or predicted by Sarbanes-Oxley. On the costs end, I would reduce what you might normally think would be the increased cost because for any company and directors who are serious about Section 11 of the Securities Act of
1933, which makes directors liable unless they prove non-negligence, the additional monitoring and the backup certifications are not going to be new, if companies are doing what they should be doing anyway for directors.

JUDGE STRINE: I'm about as close to equipoise as I get. I happen to believe that certain elements of it would have been unambiguously good. I'm close to saying that on balance that the costs outweigh the benefits. But I think given what was happening in corporate America, I think, on balance if I have to tip, I would tip toward saying it's probably better to have it than not. But I think it could have been a less-close question had people really put together a real bill and not been driven by their own political fears in the wake of WorldCom.

PROFESSOR BLAIR: And, as is so often the case, the Judge gets the last word.
PROFESSOR MITU GULATI: CEO compensation does not exist in a vacuum; it exists at the top of a structure of employment and compensation for everybody in the firm. We are interested in how this structure relates to ethical behavior. In Sarbanes-Oxley there are a number of disclosure provisions about compensation and ethics codes. What do we really think the links are between the disclosure of an ethics code or disclosures concerning CEO compensation and ethical behavior?

We will hear from first, Charles Elson, the Edgar S. Woolard, Jr. Professor of Law and Chair of the Weinberg Center for Corporate Governance at the University of Delaware’s Lerner College of Business & Economics; second, Steven Kaplan, the Neubauer Family Professor of Entrepreneurship and Finance at the University of Chicago Graduate School of Business; third, Lynne Dallas, Professor of Law at the University of San Diego; and, finally, Charles Rossootti, Senior Advisor, The Carlyle Group.

PROFESSOR CHARLES ELSON: It is unethical to pay someone for what they haven't done—that is something we can probably all agree on. Anyone who is paid for performance not rendered has acted unethically. But what do you do about it? First, we have an overpayment issue in this country. Second, we have a problem in that the overpayment was often in the form of stock options. Although it was supposedly going to incentivize shareholder-friendly behavior, in many companies it incentivized just the opposite kind of behavior. These options caused insider trading and manipulation of the company’s business and financial reports, both of which led to great benefits for the executives and left the shareholders with precious little.

Why are we at this point? There are two culprits: the compensation committees and the boards. Of course, human greed was part of the problem, too. For quite a while it was typical for a CEO to negotiate his or her salary with a board that was peopled with his or her friends. It’s very hard to turn down a friend and negotiations were quite one-sided. The CEO said, "I want X" and the compensation committee agreed. The board agreed because to do otherwise, before Sarbanes-Oxley and the new New York Stock Exchange listing rules, was likely to result in being asked not to come back the next year. Also, there was a legal dynamic that influenced things. Smith v. Van Gorkom, a 1985 Supreme Court of Delaware decision, encouraged the use of outside advisors to help boards meet the business judgment rule requirement of informed decision making. It also caused a whole host of compensation consultants to enter the picture. Compensation committees were dominated by the CEO and advised by compensation consultants — who were also often retained by the CEO. These compensation consultants used a method known as "banding" to suggest what the CEO's salary should be vis-à-vis everyone else, and no good compensation committee wanted to pay its CEO less than the 50th percentile. Therefore, as everyone was moving up each year to the 50th percentile or higher, pay rates were going up dramatically. Sometimes this was
unrelated to the actual performance rendered.

What can we do about it? First, you have to create real bargaining between the CEO and the board and the compensation committee by making the compensation committee independent of management. The full board that approves these packages should also be independent. "Independence," in this context, requires that there is no financial connection to the manager or the company, other than long-term equity ownership in the company. This is because independence gives you objectivity. Large scale equity ownership on the part of the outside directors gives you the economic incentive to argue and debate and negotiate effectively. There is a fair amount of empirical data that suggests that the greater the equity stake of the outside directors, the more CEO compensation relates to performance and is considered fair. It is rather galling to see someone overpaid. It is even more galling to think that this overpayment is coming out of your pocket. Hence there is a need for compensation committees and full boards that are independent and have a long-term interest in the company itself.

In a recent case involving Disney, the Delaware Court of Chancery suggested that directors who are not independent or who went through a rather sloppy process in negotiating pay had potentially violated their duty of good faith and were potentially liable for that violation. So, at least in Delaware courts, there is an emerging emphasis on director independence, vis-à-vis compensation decisions. The key is rethinking the compensation committee itself: both its composition and its incentives, so that there is independence and long-term equity ownership. I once heard of a board where the compensation committee consisted of the CEO and his good friends and where the CEO was chair of the compensation committee. He was asked, "Why are you chairing your own compensation committee?" He responded, "Who knows my pay better than me?" At least he had a sense of humor. But that, obviously, wasn't the right way to do things. First, we need to start with the composition of the committee and the function of the committee. The committee itself should be comprised of independent directors with equity in the company. Second, when needed, they need to be advised by compensation consultants that they retain—not those retained by the company. They need to get objective advice.

The other kind of change needed to reach more moral CEO pay structures pertains to the actual composition of pay. We relied on stock options for a long time. Stock options have their place. Unfortunately, their appropriate place was not in the compensation schemes that were created by many of these captured compensation committees. They gave away too many options and they didn't realize how valuable the options were. Also, the options were unrelated to real performance generated by the CEO, and they gave executives entrepreneurial returns for non-entrepreneurial efforts. They also created the incentive to manipulate the numbers. If an option is about to come due, one has the incentive to play games with the numbers, exercise the option, and get out. By the time the world discovers how terrible a job you have done, you're long gone. That was not a smart system.

We need to replace options with restricted stock for directors and officers. Restricted stock is a much better incentive. It's much more transparent and it incentivizes the executive both when the stock is rising and when it’s falling. Also, restricted stock doesn't create the expensing issue that you have with an option. But
more importantly, I think it is a better tool to align the CEO and the executive's interest with the shareholders. If you award the stock properly, so that the executive can't sell it as long as he is an executive or until a certain period after he has left, the incentive to manipulate disappears. This does a much better job at encouraging long-term performance. If you have to hold the stock long-term, you are going to make decisions that are in the long-term best interest of the company because the decision are also in your long-term best interest. If you err, your personal wealth suffers because the stock falls in value.

Therefore, I think that the composition of pay needs to change to a straight equity oriented system as opposed to an option system. This needs to be combined with compensation committees that are real owners of the business and who are not related to the CEO. The New York Stock Exchange listing standards, which were just approved by the SEC, call for independent nominating committees. If the nominating committee is comprised of outside directors, its members won’t fear that if they make trouble on pay, they will be replaced the next time around. These changes will bring us a long way towards a solution. There will always be greedy people and there will always be people who are being paid more than they're worth. But if we reconstruct the incentives of the system, we will get to a more moral level.

PROFESSOR STEVEN KAPLAN: I’ll start off by speaking about the history of executive compensation and then I’ll address whether the changes in compensation have been good or bad. Then I'm going to talk about what the compensation committees ought to do. Finally, I'll talk about what Sarbanes-Oxley and the new exchange rules have done and what they haven't done.

In the early 1980s, the median compensation for an S&P 500 CEO was a $1 million. I was a young investment banker then and I remember wondering, "Why are these CEOs so underpaid?" The investment bankers were making more than the CEOs and I was puzzled. The median CEO was also getting no equity-based compensation. In 1980 you had a situation where CEOs weren't paid that much and they weren't paid in equity. What has happened since? The median compensation of an S&P 500 CEO is now $6 million—at investment banker level. Also, equity-based compensation is typically greater than 60 percent of total compensation. So, there has been an increase in real terms of CEO compensation by a factor of six, and the CEO’s incentives are now much more aligned with those of the company. There were CEOs in 1980 who didn't care about their stock price; now most CEOs care passionately about it.

Have these changes been good or bad? Everyone in the media and here today claims these changes are bad; I say that they’re good. Why? The primary effect has been to align the interest of the CEO and management teams with the shareholders to a much greater extent than in the past. Compare the case of buy-out investors. When they buy a company, they're investing their own money. They are getting paid based on how well the company does. They give away 10 to 20 percent of the equity to management. If it weren't useful or valuable to give management a substantial equity stake, they wouldn't do it because it comes out of their pocket. But they do it and have done it for twenty years.

Is there any proof? If you look at the performance of the U.S. stock market
post-Enron, and compare it to the performance of Europe or Asia over any of the last five, ten, or twenty years, you will see that it outperforms the others, even with all the scandals. Even with all the “excessive compensation,” the U.S. stock market outperforms the others. And where does productivity come from? Productivity comes from running your business better. Over the last 10 years, the great period of this rise in CEO compensation, the U.S. has outperformed the world in improving productivity. The U.S. has done better than it has done in decades. I’m not ascribing causality, but it does not seem to be the case that whatever we have been doing—in terms of corporate governance and compensation—has hurt us. I believe the glass is half-full, or two-thirds full, not half empty—as everyone else seems to be saying.

So, I'm going to start from the premise that we have a good system, even if it isn't perfect. So, what were the big problems? First, options and high stock ownership increase the incentive to manage and manipulate accounting numbers. Boards were not monitoring so well and executives were allowed to sell. If you are allowed to sell, that gives you an incentive to manipulate. Second, options are hard to value. Sophisticated investors read the financial statements and understood options. The people who got it wrong were some of the boards. If you are not expensing options, it is easier to underestimate their value or to ignore them. In some cases, far too many options were given out, as happened with Larry Ellison, Michael Eisner, John Chambers, and Steve Jobs. These people had large equity stakes in their company and were getting $100 million option grants. That's hard to justify. If the CEO is already well-incentivized, a board should not give options or such a large package.

How do you solve the two problems? First, you align time horizons by giving executives compensation based on long-term shareholder value. I have a slight preference for restricted stock, but options are fine. The key is that the CEO can't sell. I am puzzled that there has not been more discussion about that. Boards should think hard about restricting when executives can sell their options or shares. If you have to hold options and shares for a long period of time, the incentive for fraud goes down. That is what buy-out investors do. They don't let management sell until they sell the company or it goes public. In other words, management cannot sell until they have performed. Second, expense options so that boards understand their true economic cost.

So, it will help if boards align time horizons, reduce manipulation, and make sure options are expensed. Sarbanes-Oxley probably helps to reduce earnings manipulation. It doesn't do much to align time horizons and it doesn't do anything in terms of expensing. SOX reduces the ability to manipulate earnings because of the increased power of the audit committee. The new exchange rules, to the extent they give the board more power, also probably make it harder to manipulate earnings. The compensation committees may be given more power and maybe the new exchange rules will help. But of the three issues, these changes only address manipulation.

To conclude, twenty years ago executive compensation was poorly structured. Now, there is greater alignment and incentives have improved greatly. It might have gone too far, but it's hard to say. Consistent with an improvement in incentives, you can see improvement in productivity numbers, in the stock market,
and in the fact that executives care about their stock price. The improvement in incentives, however, increased the incentive to manipulate earnings. In addition, options were undervalued. There are simple solutions: restrict executives from selling, reduce the ability to manipulate earnings, and expense equity based-compensation. Sarbanes-Oxley will help to some degree. Compensation committees need to step up as well; greater independence will help in that regard.

PROFESSOR LYNNE DALLAS: When conducting historical analysis, one should look at the time when stock options were issued, not only when they were exercised. This might produce a different conclusion concerning the effect of the issuance of stock options on productivity or on certain kinds of financial measures. For example, there are some studies out there showing that if stock options had been expensed on balance sheets, certain companies would have reported substantial losses rather than profits.

Today, I'm going to talk about ethical climates. I'm going to focus on a limited area relating to reward systems and their effect on ethical climates. My research addresses how certain characteristics of reward systems may contribute to ethical climates. I will briefly discuss these characteristics and then illustrate them in the context of Enron.

The first characteristic is that ethical behavior should be rewarded and unethical behavior punished.

The second is that a compensation system should not only be outcome-based, such as based on sales or profits, but also behavior-based—that is, it should also be based on the methods used by employees to reach those outcomes.

Third, the corporation's reward structure or individual self-interest should not be perceived as the prime employee motivator. Research demonstrates the negative association between self-interested climates and ethical behavior. While individual self-interest is a given, the institutional structure of the corporation should encourage and validate caring for all the stakeholders of the corporation and the persons affected by corporate behavior. Examples of reward systems that may make individual self-interest particularly salient are those that provide for large disparity in compensation within the corporation and those that include employee ranking systems. Ethical climates are driven not by executive pay levels per se, but by the disparities in pay between executive officers and the average employee of the corporation. The disparate compensation of top executives contributes to employee perception that the corporation's main function is to serve individual self-interest.

Another effect of disparate compensation and employee ranking is that they diminish teamwork. Employees are discouraged from sharing power, authority, and information with other employees as they compete to become star players. The consequences are often a lack of trust in dealings with other employees and diminished empathy for others. This often spills over into disloyalty to the corporation and its stakeholders. An additional adverse consequence of these compensation systems is their tendency to politicize corporate decision-making to a higher degree than otherwise found in corporations and to decrease the accountability of managers. Employee ranking or the availability of disparate
bonuses motivate employees to curry favor with their managers. This diminishes the likelihood that employees will take the risks of challenging the decisions of their managers for fear of experiencing their displeasure, thus managers become less accountable. Finally, a culture that discourages dissenting views results in the hiring, retention, and promotion of those who fit in or agree with existing managers, resulting in homogeneity. Homogeneity decreases the quality of decision-making and may lead to riskier decisions, including unethical decisions. Homogeneity also exaggerates decision-making biases, such as egocentric and confirmation biases that may result in less accountability in decision making. Thus, employee ranking and high disparities in compensation may validate as an institutional matter individual self-interest, decrease teamwork and trust within the organization, politicize corporate decision-making, increase homogeneity in corporate management, and decrease the accountability of managers. All of this may increase the likelihood of unethical conduct within the corporation.

A fourth characteristic of rewards systems affecting ethical climates is the degree to which employees perceive the compensation system to be fair. Employee ranking is often considered unfair because of the necessity of comparing employees who have different strengths that contribute to group production. In addition, a rewards system that has large disparities in compensation is often considered unfair, particularly when performance measures are problematic and subject to manipulation. Also, a system that places unreasonable expectations and pressure on employees may be perceived as unfair; these expectations are often found in corporations rampant with unethical conduct.

Fifth, a reward system that evaluates managers on the basis of the ethical behavior in the units they oversee contributes to an ethical climate.

Lastly, an ethical climate is encouraged when there is no expectation of retaliation for the good faith reporting of ethical violations to appropriate persons within the corporation.

At Enron, unethical behavior was not punished but rewarded if it made a profit. Employees' compensation was based on booked profits. Emphasis was on doing the deal with little consideration of how the deal would work out in practice or how it had been achieved. The focus had become paper profits, aggressive accounting, and financial manipulation. Enron utilized an elaborate ranking system. There were substantial disparities in compensation with the possibility of firing the lower-ranked employees. Every six months the entire organization geared up for extensive individual performance reviews. Self-interest was accentuated; not surprisingly, Enron also attracted individuals who wanted to make a lot of money fast. In addition, there was a lack of teamwork and trust at Enron. Employees did not share information. They locked their desks and reportedly were even afraid to go to the bathroom for fear that other employees would steal their work. Moreover, Enron's climate was highly political. The most visible consequence of Enron adopting a ranking system was the “large amount of time people spent at the local Starbucks buttering up superiors and badmouthing peers.” Officers successful at

attaining high ranks for their employees developed what were referred to as entourages and fiefdoms. Enron employees became fearful of criticizing powerful players. This had an impact on the management. CEO Jeff Skilling reportedly became more intolerant and more opinionated and less accountable. Employees describe the importance of being in the "in group," which was made up largely of "yes-men." Substantial pressures were also placed on employees to meet aggressive quarterly earnings targets. Finally, retaliations for challenging managers were prevalent. On the day Kenneth Lay met with whistle blower Sharon Watkins, a memo was delivered to Enron from its lawyers on the possible risks associated with discharging employees who report allegations of improper accounting practices.

My conclusion is that a corporation's reward system may contribute to its ethical climate. Other factors are also relevant, and may counter or reinforce the tendencies of reward systems.

MR. CHARLES ROSSOTTI: We have been discussing three different dimensions of executive pay and ethical climates. One of them concerns what is ethical versus what is unethical about CEO pay. I think Professor Elson made a good one-line summary when he said that "It's unethical to pay somebody for something that they didn't do." I think you might turn that around and say, "It is ethical to pay people a lot if they have actually done a lot." That touches on the second part of the question, which was the focus of Professor Kaplan's comments, concerning the differences in executive pay and how those differences make executives effective in moving an enterprise forward. Finally, Professor Dallas has talked about an even broader issue, concerning the effects of the way the organization goes about setting executive pay.

Executive compensation—and compensation programs in general—have an enormously powerful effect on both the performance of an organization and the ethics of an organization. But how do we make them powerful and effective in the right way, so that they help to move the profitability and productivity of the organization forward while making sure that it conforms to ethical standards? I agree with Professor Kaplan that there has been too much focus on some of the techniques, like what stock options are good or bad, as opposed to the real underlying issue. I think what is really underlying the problems that have been identified is that people have not actually been paid for what they have done. They have been paid for manipulating a process. This is corrosive for the ethical climate of the organization. So the fundamental point is to try to reach true measures of performance that people would accept as opposed to just manipulation.

I'm in the private equity business now, having been in a public company before that. In private equity we use stock options to incentivize management. We give them about 20 percent; part of that comes in options but we usually give them about 10 percent free and clear. We also encourage them to put their own cash in, to co-invest. Therefore, these people are not just directors without an economic interest who aren't paying attention. These are people that actually own the company. We will give the management 10 percent of the company, but it's not worth anything until it has been proven over a long period of time that their efforts have actually worked. That is a critical point. You can use options as a very powerful tool, but there has to be a process to make sure that people can't manipulate
accounting results or timing when they sell the options. If you can take the necessary steps to make sure that people have to hold on to the money that they have made through these options, as opposed to just being able to cash them in at a certain point in time, you remove most of the problems that you have with this powerful tool.

But even if option compensation is effective, there is still a limit. How much do you have to give someone to get them to be effective? Evidently compensation committees have either been not thinking straight or not getting good advice because they have given large numbers of options out, regardless of what the performance has been. Often it's very hard to understand why they do that. If you really owned the company, would you give them that much? The answer is no, you wouldn't. So either the compensation process has been manipulated or the committees have made bad decisions. The exchange standards are a step in the right direction as they have put forth more stringent requirements for both the independent directors as well as the compensation committee.

But one of the things that somebody needs to address, and I don't see it being addressed so far, is the role of compensation consultants. Even if you have the best compensation committees and the best people, they are still independent directors. They are not going to be able to sit down and do calculations. They are going to have to rely on somebody. You end up relying on the compensation consultants. I don't want to cast aspersion on any particular professional group. But I would have to say that this is the least competent professional group that I have encountered in 33 years. They don't say that they want to set compensation at the 50th percentile. They want to set it at the 75th percentile. I was talking to somebody who chairs a compensation committee and he challenged one of the compensation consultants. The consultant said “Well, everybody gets paid at the 75th percentile.” That is just conceptually flawed.

But is there a substitute? The compensation committee members are not going to sit there on their own to devise a plan. So there has to be something that provides the committees better professional support. In the private equity world, we don't use compensation committees. We look at our other portfolio companies that have been successful and say, "What do we do for those people?" We have our own internal market, but I don't know how you would do that for a public company.

I think there is a strong link between how executive compensation is set and how it affects the ethical corporate climate. But it is not based entirely on the degree of disparity. I haven't heard many people at Microsoft complaining, even though Bill Gates is one of the richest men in the world. Nor have I heard many people complain about Warren Buffet and how much money he's made in the stock market. Nobody believes that either one manipulated anything to get the money. The real corrosion occurs when the upper ranks are not getting paid for what they have done, but are being paid based on their ability to manipulate the compensation committee, manipulate the performance targets, and manipulate whatever else they need to manipulate to get the result that they want. The real key to making compensation conform to ethical standards in the company is to have it be truly performance-based so that if there is no performance there is no pay. That is the message that is being sent out in most of the companies that are performance-oriented. If the top three executives are the only ones that are exempt from that formula, it pretty much
undermines the standards.

It can also be problematic if the performance standards and the bonus are tied to quantitative numbers too narrowly. If that happens, the company may claim to have a strict ethical code of conduct, but in reality it only looks at a single number when considering promotions. So, there has to be something going into evaluations besides the quantitative performance numbers—because not everything can be put into one set of quantitative numbers.

PROFESSOR ALAN KAUFMAN (School of Business at the University of New Hampshire): A compensation standard determined in the market is very tough. Some people get hurt when productivity goes up. There are losers. Unless they are compensated, you could say there is something unfair.

It is true that managers lost out to investment bankers in the 1980s. That was a takeover period and they knew it and they got really angry. The big shift takes place in the next decade with the change in the tax code. You see very positive performance in the economy. There has been a stock market surge in the U.S. and increases in productivity. These are things that we really want, and those results were in part due to incentivized CEO pay. But you also see an internal change within corporations. It used to be there was an in-house labor market. By the end of the 1990s we see a tournament where everybody rushes to become the CEO and the kind of culture that Lynne Dallas describes. There is still a kind of clubbiness about independent director review of compensation; most of these independent directors are either retired CEOs or current CEOs. Even as we have seen increases in productivity, it’s important that the gains be shared all the way down the line. We have also seen a period in which people's living conditions have just been gutted. We have seen an actual decline in median income. That is troubling, ethically, given the huge gains that are being made.

PROFESSOR KAPLAN: Over the 23-year period from 1980 until today, living conditions and GDP per capita have gone up. Admittedly, they have gone down in the last several years. But there was a bubble economy for a period, so I would not look at the recovery period from 2000 to 2003. Rather, I would look at 1990 to 2003. That being said, this is an issue; it's not a CEO or compensation committee issue, but a political issue. The ethical issue for the corporation is to make sure it’s doing what's best for long-term shareholder value and that it's doing it legally. That's why I think the goal should be to make sure the CEO and the management team can't cash out before the value is proven. If that happens, poor decisions that hurt the company will show up in the stock price before the stock can be sold and the CEO won't make those decisions.

PROFESSOR ELSON: Compensation is morphing from a fairness issue into a managerial issue. Recently, I was at the Wilmington train station and there was a train cancellation. Everybody rushed to the ticket line and tried to figure out how they were going to get to where they were going to go. Two of the people ahead of me obviously worked for a particular company, because they kept talking about it. They were talking about the company’s CEO, who had just been featured in an article asserting that he was grossly overpaid. They reached the counter and the lady at the counter told them that they could get seats on the next train—the cheap
one—or on the one before that, which only had very expensive first-class seats available. One looked at the other, snickered, and said,"To the shareholders." They then put their credit cards down and went first class. That tells me that compensation in that company has become a managerial issue. They said,"Look, if this person is making all of this money, why am I being asked to take the cheap train, to stay at the crummy hotel, and to save staples? Enough." As the disparity in pay within companies has increased, I think you have created a managerial issue.

Wage stagnation is an issue; people are going to get fed up. While the goal is to maximize shareholder value, compensation is beginning to create problems. It's going to be a lot tougher to incentivize within the organization if the spread becomes too great. Because people say,"Why should I economize and end up putting it in your pocket as opposed to the shareholders’ pockets?" The issue now is,"By paying this person this much, are we sending the wrong signal within the organization that will make it more difficult to incentivize people to make the right decisions?" Also, we have developed a CEO-centric culture. The CEO may drive the company’s results, to a degree, but there are many other people in the organization that are necessary to drive those results.

PROFESSOR CLAIRE HILL (Chicago-Kent Law School): Lynne Dallas condemns the so-called star system at Enron, but I have heard that Sharon Watkins was actually trying to ingratiate herself with Ken Lay, not engage in “virtuous whistle-blowing.” So, maybe the system is not always so bad.

But I also want to ask a question concerning the ability of corporations to craft financial instruments that do all sorts of amazing things, like allowing you to hold something long-term yet financially be in the same position as if you only had to hold it very short-term. How much do you think that's going to be a problem? How much would you try to solve that problem? How confident are you that you would succeed in getting the bulk of CEOs, or board members, to hold onto shares for the long term, given the existence of financial engineering in its sophisticated forms?

PROFESSOR DALLAS: With respect to Sharon Watkins, her motivation really has no relationship to the comment I was making, which concerned the retaliatory climate. That she in fact wanted to impress Kenneth Lay fits into the notion that there were really powerful managers there that the employees wanted to impress in various ways.

PROFESSOR ELSON: With respect to your second question, it has been revealed that many people effectively were buying hedges against their options. They were sort of betting against themselves, which means they had their cake and were eating it, too. Boards should prohibit CEOs from purchasing hedges that minimize the impact of their equity positions in the company. They say,"Yes, but I need to minimize my risk for estate planning purposes." But the head of a company who is supposedly getting entrepreneurial returns should not then be able to refuse to take entrepreneurial risks. If you find out that they are buying such hedges, you fire them. If they withheld the information from the company, it would be a reason to terminate them for cause.
PROFESSOR JILL FISCH (Fordham Law School): We know that one dollar of compensation under a stock option grant is less appealing to executives than one dollar of cash compensation because the option is going to be discounted for the firm's specific risk. If you make the executives hold the stock for the long term, they're obviously going to discount it a lot more. We also know that unless companies have to expense stock option grants, it's kind of “funny money.” But if companies have to raise the total amount of the stock grant to make up for discounting by executives, it's going to cost them even more. At some point does the trade-off stop making sense?

PROFESSOR ELSON: Dividends would be part of the deal. A large part of the problem has been that a good deal of capital has been locked in the company; it doesn't go back to the investors. If you start using restricted stock as opposed to an option long term, the executive would have an incentive to get the money out. The result would be a responsible dividend policy.

PROFESSOR KAPLAN: That's a very academic, economics-based comment. The idea that the stock option or restricted stock is worth less because it is volatile in cash-terms reflects an assumption that the executives are risk averse. But given how wealthy they are, I'm not sure how risk averse they really are; they may be close to risk-neutral. Also, there is a behavioral aspect to this discussion. David Larker has written a paper asking people to estimate the value of their stock options. Some people overvalue their options considerably because they like their company and they like its prospects. So it's not entirely clear to me that they'll discount in the way you predict they will. From an economist's academic perspective, they should do that. But I don't know how well that theory works in practice because sometimes people like their own stock, and also they may not be that risk-averse.

PROFESSOR FISCH: Economic evidence indicates that executives do discount. For lower-level employees, you might be right. But if the incentive component is going to work, the amount of stock and the risk associated with it has to be economically significant. You can't have it both ways.

PROFESSOR KAPLAN: It has to be economically significant, but if they are risk neutral and it is economically significant, then they will work harder. Whether they are risk neutral or risk averse, as long as it is economically significant and they can affect the outcome, it has an incentive effect.

MR. ROSSOTTI: If you are talking about lower-level executives, your point appears valid. But why would I hire a CEO who has so little confidence in his ability to increase the value of the company that he is discounting the value of his options? If he is doing that, the board should get rid of him and get a CEO that believes in what he's trying to do. I have seen companies where people do discount the options or overvalue them. It can be either way. It depends on the character of the company and the kind of employees it has, in terms of whether it makes sense to use options further down. But in terms of the CEO and the top team, you need to have a set of people who believe enough in what they're doing over the long-term that they're willing to risk a substantial part of what they're going to gain from it. Otherwise, they should not be in that position.
PROFESSOR DALLAS: To create a team that believes in the company, executive committees should not only compare executive compensation to compensation at other corporations, but should also consider what the difference is between the CEO's compensation and that of the average or lowest paid employee. That difference should then be publicized, which may lead many investors to believe that the company is being operated in a more responsible fashion. In the past productivity generally resulted in higher wage levels and the wealth was more evenly distributed. But what we now find is that a lot of that wealth is going to capital, most of which is held by 10 percent of the people in the United States.

From a macro-economic point of view, such a change in setting executive compensation packages would be a good thing. This would contribute to an ethical climate. As executive compensation has increased, the income disparity between the CEOs and the lowest paid employees has grown tremendously and it is much greater than anywhere else in the world. This has caused corporate climates to change for the worse in the United States.

PROFESSOR CINDY SCHIPANI (University of Michigan Business School): In terms of independence on the compensation committee, our rules address financial independence from the company and the need to avoid having relatives of the CEO on the committee. They don't seem to get to the clubbishness part of it. But is clubbishness perhaps really at the heart of the problem? We have a retired CEO as an adjunct faculty member who runs a course in crisis management and he can get just about any CEO to come to campus, whereas the rest of us probably cannot do so. There seems to be a “CEO club.” Should we prohibit retired CEOs from serving on boards or worry about interlocks or try to eliminate the social clubbishness?

PROFESSOR ELSON: Having CEOs on a compensation committee is a problem. They have an incentive to approve big packages because they know that the banding of salaries will cause those packages to benefit them sooner or later. Yet, the toughest critics of CEO compensation packages are not the academics; they're the retired CEOs. Like retired baseball players, they get angry about what everyone is earning now.

I think interlocks are easy to ban. That's pretty simple. But how do you get at the social relationships? That's a lot tougher. That's one reason why many people have been pushing the concept of equity, because ownership separates you from the social relationships. When your own house is on the line, you're going to be a lot tougher. Quasi-financial relationships are also an issue. Vice Chancellor Strine in the recent Oracle opinion pointed out that even though there may be no direct financial links, there are some quasi-financial links that have to be considered. The courts have moved nicely in that direction. But we'll never eliminate the social relationships, so we’ll have to use equity ownership.

MR. ROSSOTTI: I think it’s a mistake to view CEOs as a category, rather than as a set of people with diverse attitudes. CEOs differ greatly in their viewpoints on these topics. I know many of them and some of them believe that companies should pay very well for excellent performance, but pay much less for poor work. Others are more tolerant of high pay for mediocre performance. Just because they're
CEOs doesn't mean they come equipped with a certain set of attitudes.

MR. CHARLES OLSEN: Some of the compensation consultants—such as Hewitt, Towers Perrin, and Mercer—regularly send their surveys out to everybody. So everybody uses those same standards. A lot of these figures were developed when human capital was increasingly used, rather than wealth capital, to measure value for these corporations. At Enron, the top 200 officers all earned a million dollars or more. This is why a congressional committee said that Towers Perrin was a rubber stamp for management. So I would tend to agree with Charles Rossoiti about using more empirical data, perhaps from a comparable industry. But I don't think a compensation committee can do that. So how do you address that compensation committee issue?

PROFESSOR ELSON: I used to view compensation consultants quite negatively. At one point I even got a call from one who said, "Do you really understand what we do? I think you will find we are very professional. Why don't you spend six months with us? You can just follow us around to see what we do." I accepted the offer and followed one of these consultants around and I learned a couple of things. First, they can be manipulated, like anybody else. But if they are honest and they are distanced, and their incentives are right, and if it is clear that they represent the committee, they can be very helpful. If they’re improperly used, they become a rubber stamp. It’s the same way with lawyers, unfortunately. We can be just as venal as anyone else.

I chair a compensation committee and following this experience I decided to use a compensation consultant. I found one who agreed not to do work for the company and had not worked for the company before. He pointed out some things that I wasn't aware of and was extremely helpful. I think that he saved the company and the shareholders a good deal of money. The problem occurs when the compensation consultant is really hired by management, so that their incentive is to raise management’s pay levels so that they stay engaged. I think they can add value, but they can very easily be abused and that's why you have to be very careful. This is why the composition of the compensation committee and its incentives are so important.

JUDGE LEO STRINE: I heard Mr. Rossoiti say, "How could committees hire these compensation consultants?" It really makes me queasy when I hear that capital doesn't know how to hire labor. Won't the supply come if the demand exists? As soon as compensation committees say, "We want someone to work for us who is going to negotiate a market-based approach to CEOs," won’t people fill that role eventually? How many of you in your experience on compensation committees have asked about the average raise the company has historically given at different ranks? If you did, then you could say, "We only gave an average raise of 2.5 percent to middle management this year. You're asking for 12 percent. Why are you so special that it is worth inviting the morale problems that would come with giving you 12 percent while everyone else gets 2.5 percent?"

MR. ROSSOTTI: I believe that you can get competent support from consultants. I think the problem is that it takes a lot of work on the part of the compensation committee to do it effectively. You have to have competent
professionals and you have to have people on the compensation committee who are willing to get into the details and look hard and ask questions and get into the substance of what's being recommended or what data is being provided by these consultants. They can’t just abdicate their responsibilities to a bunch of consultants.

PROFESSOR ELSON: That's why the compensation committee and the full board have to be independent and self-perpetuating. Traditionally, if you objected to the CEO’s compensation, you were gone very quickly. But the dynamic has changed.

MR. JACK BOGLE: Over the last 15 years, CEOs promised the marketplace earnings growth in an ascending line averaging 11.5 percent a year. They have delivered 3.5 percent a year. Our GDP growth has been 6.5 percent a year. Yet their compensation went from $2 million to $11 million in that period. I think that is 450 percent, which is incredible considering that the average compensation of their employees grew 3.5 percent. This is an economically unacceptable system.

As a former CEO, I can say that CEOs—including myself—are terribly overrated and terribly overpaid. I wasn't paid nearly as much as some of these other gods, but I was still overpaid. But I have a solution that I would like to suggest. We can develop a ranking, looking at 12 companies. We can divide the 12 CEOs into 4 quartiles and rate them from 1 to 12. Then we can have another column next to it, listing their return on total capital compared to their peers, times their return on total capital compared to American industry generally. If someone is first in Column 2, then they can be first in Column 1. But if you don't do as well as the GDP in the group, you don't get anything. It means that you really have to succeed to get paid a lot of money and you'll be compared to your peers on a fair basis. Why has that second column never appeared in any compensation committee I've served on?

PROFESSOR KAPLAN: I want to disagree with your claim that they haven't performed well, because they have. In the last 20-25 years, the stock market has done spectacularly and some of that has to be attributed to management.

MR. BOGLE: I don't think the price of the stock had much to do with the value of management.

PROFESSOR KAPLAN: Then you and I disagree. The second part of your question, which is a puzzle, asks why there isn't more relevant performance evaluation. Whether you go to restricted stock or to options, you can index them to the S&P or to the industry, and you can vest them only if you outperform. I think GE used something like that for Jeffrey Immelt. Compensation committees should be experimenting in that way. I think they haven't in the past because of the expensing issue. If we make companies expense options, I think you will see more experimentation.

MR. BOGLE: Regarding Jeff Immelt, it is not based on the price of GE stock, which happens to be down 50 percent. It is based on increasing the company’s cash flow, at 10 percent a year. I think that's a very good plan.

PROFESSOR KAPLAN: But then he got stock.
MR. BOGLE: I don't mind getting paid in stock.

PROFESSOR KAPLAN: Experimentation is good and it ties him more toward long-term shareholder value if he performs, which is what we all agree on.

PROFESSOR BAGLEY: I certainly agree with Steven Kaplan's argument that many of the problems we have seen exist because executives can now flip shares. It's very easy to time it. Indeed, it's one of the unintended results of a change in the SEC rules on short-swing trading. In the past, you had to hold the shares for at least six months before you could sell them. The SEC changed the rule and said, "So long as the stock option plan is approved by the shareholders, you can immediately buy and sell." So you don't have any exposure to risk.

We have been talking for the most part about tying executive compensation to shareholder performance. Considering the data that you were just indicating, do we run a risk when we tie executive compensation so tightly to shareholder return, even if it is shareholder return over something other than a very short period of time? To what extent should we be measuring things within the corporation that we think are a proxy for things like ethics and fairness? Part of the impetus for my question is a quote from one CEO who said, "My responsibility is to maximize value for my shareholders and to do what's best for them. I can't let my own sense of right and wrong get in the way." I wonder whether we are letting managers do things, under the guise of shareholder primacy, that ultimately are not in our best interest as a society?

PROFESSOR ELSON: But in the long term unethical behavior by the corporation is devastating to stock prices. Over the long term, the market has always been an effective proxy for value. I think if you use internal methods of measurement, like corporate ethics, they would be subject to manipulation. Enron had a Code of Ethics, but obviously something went wrong there ethically. The market over the long term does a very effective job of valuing a company's prospects and companies that don't function ethically don't last a long time in the marketplace.

PROFESSOR DALLAS: But you have to look at how people interpret the objective of the corporation. How do they interpret profit maximization? How do they interpret shareholder return or value in their operational decision making on a day-to-day basis? There are a lot of people in this room who would want to expand the purposes of corporations to include stakeholders. But that is very hard to change because you would have to change a substantial norm in the United States, which is to maximize shareholder value. It would involve substantial changes in the way we think about corporations and what their purposes are.
PANEL V
SECURITIES REGULATION AND CORPORATE DISCLOSURE: TOO MUCH TOO FAST?

PROFESSOR JEFFREY BAUMAN: To my immediate right is Jim Cox. Jim is a professor at Duke and coauthor of what I consider the leading case book in securities regulation. To his right is Joel Seligman, who is the dean at the Washington University, St. Louis School of Law. Joel is the preeminent securities regulation scholar. On my far right is Peter Wallison. Peter is the codirector of the financial deregulation project and a resident fellow at the American Enterprise Institute. He is a former General Counsel of the Treasury Department and he was White House counsel to President Reagan.

DEAN JOEL SELIGMAN: Let me address questions such as, "How well is the S.E.C. doing?" "What went wrong in the late 1990s?" and "How can we avoid a future Enron?"

The late 1990s was a period of dysfunction in terms of deterring fraud. I would like to offer some explanations as to why—amidst the most sustained and successful bull market in the history of this country—securities regulation deteriorated so badly. The period between 1920 and 1927 was one in which the relevant indices, such as the Dow Jones Industrial Average, doubled; then between 1927 and late 1929, they doubled again. This kind of accelerating bubbling at the end of a sustained bull market was clearly evident from about 1980 to March of 2000, when you saw the market capitalization of the New York Stock Exchange increase almost twelve-fold. The Dow Jones Industrial Average was trading roughly in the 4,000 level at various points in 1994 and early 1995. By 2000 there were moments when it was over 12,000. By the end of the 1990s, the new economy themes heard in the 1920s were again resonating. We all remember the dot-com boom.

There are costs to market booms and one is a general sense that regulation matters less. Support for regulation vanishes when the market is going up 30 percent each year, as it was in the late 1990s. In those situations, support from both the White House and Congress deteriorates. Between 1995 and 1998—the very heart of this extraordinary surge—there was not one staff position added to the S.E.C., even though the number of registration statements more than doubled between 1993 and 1999. In certain core functions, the S.E.C. was overwhelmed. By the late 1990s, the Division of Corporation Finance had abandoned the general principle of reviewing each 10-K every three years and was instead reviewing them about every six years. Morale deteriorated to such a level that you saw an effort to unionize the S.E.C., which succeeded in 2000 by almost a two to one vote.

The S.E.C., which has usually had a pretty good reputation, was undermined in part because of inadequate budget and in part because of an inability to fully perform the traditional and less exciting core functions like document review, inspection, and compliance. It was still an agency of about 3,000 people; it could muster 62 people to look at Internet fraud. But at the same time it wasn't keeping pace. This explains in part why the Commission did so poorly with respect to research analysts, a problem that was very much on their radar screen and discussed
within the Commission. Concerning certain aspects of the Commission's mission, the late 1990s was largely a holding action. It was a period where the most important things going on in the Commission were trying to reduce the ultimate thrust of various new forms of congressional legislation and to hold on to a budget.

Also, during this period, support for other aspects of what we considered fraud deterrence deteriorated significantly. In private securities litigation, a series of new laws was passed in the 1990s, perhaps the most important of which is the 1995 Private Securities Litigation Reform Act. The National Securities Markets Improvements Act in 1996 and the Securities Litigation Uniform Standards Act in 1998 are part of the same story. In securities regulation there are often pendulum swings. Part of the time the basic question is, "How do you prevent insiders from exploiting conflicts of interests and enriching themselves at the cost of shareholders?" The other part of the time, as we saw during the 1990s, the insiders are the heroes and the lawyers—painted as the avaricious plaintiffs' attorneys—are the villains. Both extremes of the pendulum are wrong and oversimplified. But it was clearly the case that by the 1995 Act, Congress was fully prepared to clip the wings of what they saw as the abuses of private securities class action. The Supreme Court made significant contributions, particularly in 1991 with the Lamft decision on the statute of limitations and much more so in 1994 with the Central Bank decision ending liability under Rule 10b-5. The signal was sent that you had a weaker S.E.C. Private securities class actions became less of a force as complaints were increasingly dismissed and the Rule 9(b) motion was used more often, signaling that there was going to be less force to fraud enforcement.

Now we have a concurrent system in securities regulation. We have federal securities law at the federal level and Delaware fiduciary standards at the state level. There have been times when federal law has been inadequate and state law has stepped into the fray. For example, state law judicial standards with respect to tender offers provide a more articulate standard than what was produced by the Williams Act. With respect to the major fiduciary duty question of the 1990s, which was excessive executive compensation, there was almost a systematic collapse at every level. In the early 1990s there was an FASB attempt to expense stock options, but the FASB was persuaded to instead develop a disclosure system that doesn't work very well. There have been so-called waste actions to challenge excessive executive compensation, but for the most part these didn’t work well in the 1990s. They reached a crescendo with the Brehm vs. Eisner case in 2000 where the Delaware Supreme Court dismissed a complaint with leave to amend and replead. This happened despite the fact that the Delaware Supreme Court described the Walt Disney board as, "sloppy, if not casual, and perfunctory." Thus, $140 million could be retained by an individual who, by the facts pleaded in the case, both at the Chancery Court and the Supreme Court, was barely doing his job. He was alleged to have spent most of his time polishing up his resume and looking for new challenges. $140 million for fourteen months of doing this and they couldn’t even bring this matter to trial. That is a very powerful signal to Wall Street. There is very little sense that there is going to be much restraint on executive compensation at the Delaware level, which is very important given how consequential Delaware is in our concurrent system of federal securities and corporate law.

Another factor—the one that was of most immediate consequence to
Sarbanes-Oxley—was the apparent deterioration in the quality of auditing. This is a story, in part, of an auditing process beset with conflicts of interest. There was growth in the significance of management advisory services so that, by 2000, approximately 50 percent of the income of the Big 5 accounting firms was coming from advisory services and slightly less than 30 percent was coming from auditing itself. Auditing, the Wall Street Journal put it, had become the loss-leader. There were very few instances of auditors saying “no” under circumstances where 20 years ago, when auditing was largely what accounting firms did, the firms might well have said “no.”

In effect, there were many factors in place. There was tremendous enthusiasm for the idea that we don't really need regulation; there was some deterioration of the S.E.C.; there was clear hostility in many quarters to private securities litigation and fiduciary duty standards; there was a failure to pick up the lag at the state level; and there was deterioration in the quality control of auditing services. All of this ultimately culminated in a series of multi-billion dollar failures, beginning with Enron and concluding—for purposes of legislation—with WorldCom in mid-July of 2002. The Sarbanes-Oxley Act is a response to these problems. It is most significant and best drafted in Articles 1 and 2, which address the establishment of the new PCAOB and conflicts of interest. It is randomized in its quality in Articles 3 through 11. A good deal of it was done through fly-by-night drafting. Some sections—like 402, which bars loans to officers and directors—is an overreaction to Bernie Ebbers receiving $137 million from WorldCom. But the basic core of the Act, which focuses on how we can strengthen auditing and reduce the conflicts of interest in the auditing profession, is very significant. If the Act becomes the most significant federal securities law since the New Deal period, it will be because of its contributions in strengthening auditing standards and reducing auditor conflicts of interest.

Sarbanes-Oxley, however, failed to address several problems. It did not address aiding and abetting, and if you want to deter auditor misconduct, aiding and abetting is an excellent place to start. The issue that was thought about in the process leading up to Sarbanes-Oxley, but as one Senator said, “Congress just didn't have the votes to address it.” I'm fully aware that there is a good deal of potential in the kind of decisions that Judge Harmon has issued in the Enron case; decisions that will reduce the significance of pursuing this. But I don't know if that decision is going to hold up and I think it is worthwhile taking a hard look at whether or not this scenario needs further attention.

If one looks at the excesses of the 1990s, the most significant one that wasn't addressed by Sarbanes-Oxley was executive compensation. The FASB will probably soon have some standard for expensing stock options. What the 1990s have demonstrated is that you can have any number of standards and disclosure rules, but they don’t work well if they are not enforced. I'm intrigued by the possibility of a federal waste standard. I am very cognizant of Section 36(b) of the Investment Company Act, which, in effect, is a federal waste standard—but in the context of mutual fund advisory fees.

I'm intrigued by the sense that Delaware moves in one direction where it is most effective, typically in protecting investors when it is most brutally criticized,
and then tends to have its own pendulum swings in the other direction. I'm intrigued by the idea that if a narrowly-tailored standard similar to 36(b) could be adopted for registrants under the Securities Exchange Act, it might in a meaningful way deter not so much fraud, but what in many respects was the most conspicuous abuse of the last Gilded Age from which we now emerge. That is one item that really hasn't been discussed.

MR. PETER WALLISON: I am a critic of Sarbanes-Oxley. I think it was unnecessary and went too far. Joel Seligman said that the significant thing about Sarbanes-Oxley is the regulation of accountants. I believe this to be one of its most significant weaknesses. It sets for the S.E.C., and for investors, the idea that GAAP financial statements are the only significant and important financial disclosures that corporations make. By insisting that the audited financial statement be emphasized through the regulation of the auditor, the idea that Congress seemed to have in mind —and I think they were pushed in this direction by lawyers—is that an audit can be made accurate and that the more accurate it is, the better it is for investors. That is simply not true.

Audits cannot be made more accurate. Even if they were made more accurate, they would not be any more informative. The reason for this is that, under GAAP, there are dozens of choices that are made by management in deciding how their financial statements should be prepared and what the results of that preparation will be. We know this by looking at the markets. In fact, many people have complained about earnings management by companies. Companies regularly suggest that they are going to reach a certain level of profitability for a quarter. If they make that mark, or they exceed it by a penny or two per share, and their stock might move slightly as a result. But if they don't make it, the stock can decline by 20 percent. Why? The reason is that analysts know that if a company makes the numbers that it has suggested it will make, then it still has some profitability left somewhere in its operations. But if it fails to reach the level that it has signaled it is going to make, the company’s management has run out of ways to manipulate their numbers.

We should have other ways of looking at financial statements and company financial disclosures. In fact, while Enron was talking about earnings growth and reporting earnings growth, its stock was declining relative to its industry. In other words, some investors were looking at something other than earnings. Not all investors were doing this, unfortunately, but the sophisticated investors were looking at the company’s cash flow. The cash flow of Enron was declining while the company was showing increasing GAAP earnings; many investors thought there was something very fishy there, and there was. We now know it was a fraud. Congress, then, should not have emphasized in Sarbanes-Oxley that GAAP financial statements are the only and most significant financial disclosure that corporations should make. Cash flow is at last equally important. Yet, by creating a board (the PCAOB) that will regulate the activity of auditing, we have done exactly that.

The PCAOB will impose enormous and needless costs on the American economy. The first way it will do this is very direct. This board is not a government agency; it's a private company. It's a not-for-profit corporation established under the not-for-profit laws of the District of Columbia. It is not intended to be a government organization, although it is supervised by the S.E.C. It is supported by levies on all
of the public companies in the United States based on the ratio of their market capitalization to the entire market capitalization of public companies. So the first thing that we know about this board is that it can grow as large as it wants and it can impose costs on all public companies. The second way it will impose costs on the economy is that it is now articulating a set of regulations that will be very expensive for accounting firms. Accounting firms will be required to have large staffs to comply with the board’s regulations, and those costs will be passed through to the clients of the accounting firms, which are, again, the public companies. So not only are these public companies supporting the board’s costs, but they are also supporting the costs that the board is going to be imposing on the accounting industry. Finally, as is true of all regulations, it will keep out new entrants. If you are a small accounting firm and you have 50 clients, you are not going to be able to compete with the larger organizations because you have to spread the cost of regulation over 50 clients whereas they can spread it over 500 or 5,000 clients. Today, there are four large accounting firms. I predict that we will only have four large accounting firms that will be doing audits in the future. As a result, companies will be forced to pay whatever fees these accounting firms will charge for their audits. There will be no substantial competition for these big four firms and it will be very difficult for companies to find accountants who will be able to do their audit work. So, we have for no good reason imposed tremendous costs on our financial system.

The second thing I would like to point out about Sarbanes-Oxley is that it is based on a faulty premise. Some of that can be seen in the title of this conference, which is, "Restoring Trust in America’s Business Institutions." The notion underlying Sarbanes-Oxley is that corporate managements cannot be trusted. This is because of Enron, WorldCom, and their ilk. But even if this were true, even if corporate executives were as a whole a corrupt group, the idea that it is possible to prevent fraud through regulation was misplaced to begin with. Many have discussed whether the S.E.C. should have more authority and should have received more appropriations in order to prevent events or frauds like Enron. But no matter how much money the S.E.C. is given, it could never prevent fraud, which by its nature is concealed. What we had in the case of Enron and in the case of WorldCom was concealment of fraudulent, manipulative, and deceitful activity. Handing over more authority to the S.E.C. or giving them more money in order to prevent fraud never would have worked.

The principle that Sarbanes-Oxley attempts to develop is the idea that independent directors are going to be able to regulate how corporate managements operate and that to some extent they will have a salutary effect on how corporate managements operate. But that is wrong. Sarbanes-Oxley requires only that the audit committees of public companies be made up entirely of independent directors. But the principle underlying this was that the management of the company cannot be trusted in the preparation of the financial statements, the retaining of independent auditors, and the management of independent auditors. Given the principle that you cannot trust managements, it was understandable for the New York Stock Exchange and NASDAQ to adopt rules that required all companies to be managed by an independent board of directors. The S.E.C. just approved the rules of NASDAQ and the New York Stock Exchange, which will require all companies in our economy that are publicly traded to be managed by a board of directors that is made up of a majority independent directors. The characteristic of independent directors is that
they are ignorant of how these very complex companies actually operate. They are unfamiliar with the details. So, they will be extremely cautious and conservative about the risks they want to approve. As a result, I think we have turned over the management of most of the companies in our economy to people who are largely risk-averse. One of the reasons why it has taken so long for a recovery to develop in this country, after the collapse of the so-called bubble, is that managements have realized that they have to be extremely cautious about making certain kinds of investments, making acquisitions, building new plants, or taking risks, because they are going to have to deal with a group of independent directors who are averse to risk. Their view will be, "Look, we are making profits as we are. Why should we take any further risks and risk losses?" That will be the result of the idea that underlies Sarbanes-Oxley that corporate managements cannot be trusted.

We could prevent bad decisions by corporate managers, by penalizing risk-taking. If we want to prevent car accidents, we could also insist that no car is manufactured that can go more than 20 miles an hour. But is this sensible? The idea used to be that we should give incentives to management for risk-taking. Sarbanes-Oxley has done precisely the opposite.

PROFESSOR JAMES COX: I would like to share with you a few insights from “SEC Enforcement Heuristics” which I coauthored with Randall Thomas at Vanderbilt and Dana Kiku, an economist at Duke. S.E.C. enforcement actions have to be seen as dramatic evidence of regulatory failure. If they really had sufficient resources in the 1990s, then the Corporate Finance Division, that sleepy division of the S.E.C., would have caught a few things. It is clear that if someone had spent some time looking at the Enron footnotes, they would have seen that there were some serious problems. This is an illustration of how enforcement actions arise because you haven't protected investors earlier through a review of a registrant’s filings.

Sarbanes-Oxley has nothing to do with financial accuracy. It has everything to do with the culture in which information gets into the public domain and with making that process more trustworthy by instilling in it various participants in gatekeeper roles. It's not about accuracy; nobody ever thought that accounting was about accuracy. I say that as a former accountant. It has everything to do with the central word for the profession—public. Accountants are gatekeepers and that is why the most significant parts of Sarbanes-Oxley are Chapters 1 and 2. What piqued my interest in doing my recent study was, "Do we really need private actions if we have a well-funded S.E.C.?” That gets into the question of the inefficiencies of a bureaucracy and the heuristics that it brings to its task in trying to figure out what misconduct to sanction. My co-authors and I have expanded our earlier study and found that, at least in the private litigation arena, it is not working very well. Over half of the financial institutions with sizable claims never claim the money that is already in the settlement pot. Our paper addresses those companies leaving money on the table. Has the public—i.e., S.E.C.—enforcement effort also failed to achieve their objectives?

“S.E.C. Enforcement Heuristics” asks the following question: “What do we learn about S.E.C. enforcement heuristics by comparing and contrasting the heuristics of private litigants in suits?” Our database consists of cases that were brought between 1990 and 1997—248 of them—about half of which occurred before the PSLRA-effective date. We tried to determine how many of them had a parallel S.E.C. action and then we tried to glean something from that.

I am going to list the findings of our study and then I am going to end with a speculation. We found that after you have a private settlement and it is coupled with an S.E.C. enforcement action, the settlements—in absolute dollar amounts—are 50 percent greater. What we also find is that when you have an S.E.C. action and private actions combined against the same issuer, those settlements occur about seven months faster. Our intuition is that the issuer decides that it wants to “put this all behind us as fast as we can.” So settlement is going to occur a lot quicker in part because there is a lot more information out there to help the plaintiffs.

It is interesting to evaluate the targets the S.E.C. looks at. We looked at several databases, not just our 248 cases. They consistently show that the companies that are a target of a private securities class action in which there is no parallel S.E.C. action have a market capitalization two-thirds larger than when there is a parallel the S.E.C. action. So that the S.E.C. brings its actions against companies where the market cap is roughly one-third the size of the market capitalization of private suits where there is no parallel S.E.C. action. We next analyzed three different items to see if any explains when the S.E.C. will more likely bring an action or not. All the test results were statistically significant at the 5 percent level. I'm going to list the three factors and you can figure out which ones explain it. One is asset size. Are you more than likely to find an S.E.C. action the larger the asset size of the firm? The second is provable losses. We had to tinker with our model for about five months to get a model of the losses suffered by the class that seemed to make sense for our database and scale it by market capitalization. So provable losses scaled by market cap is the second factor. The third factor is financial distress. So the three factors are: asset size, provable losses that are scaled by market capitalization, and financial distress. The results indicated that the only positive variable, and one that is statistically significant at the 5 percent level, is financial distress.

PROFESSOR BAUMAN: The real theme here is not “how could we have caught Enron in the first place?” but “how do we prevent another Enron?” But what does it mean to prevent another Enron? To what extent is the S.E.C. equipped to lead that effort and if not the S.E.C., then who or what?

PROFESSOR COX: I would like to take the first part of that question and that is "another Enron." Many people have analogized Enron to the perfect storm. Why do we make that analogy? Partly, it is because all of the gatekeepers failed. If any one of those gatekeepers had stepped up and done his or her job, we would have learned of Enron a lot earlier and the losses would have been a lot less. Preventing another Enron means preventing the S.E.C., the analysts, lawyers, accountants, directors, and audit committee members from all fumbling the ball in the same game.

PROFESSOR BAUMAN: To what extent were there incentives in the system to not want to know? You didn't add the press, for example, as you might
have. They're not formal gatekeepers but everybody had an incentive to not want to know because everybody was making money from not wanting to know.

PROFESSOR COX: I think you answered the question. The incentives were all structured incorrectly. The financial press always has problems because only so much of the information is actually available to them. The press did ultimately break the story. When they hinted that Andy Fastow had a deal going, it really caused the house of cards to fall down in August of 2001.

DEAN SELIGMAN: The question is not “how do you prevent another Enron?” I think the question should be, "What's the appropriate securities regulation policy?" Traditionally, we recognized it requires a balance. On the one hand, there needs to be a focus on fraud deterrence, which addresses how you prevent another Enron. On the other hand, there needs to be a focus on capital formation. The concern I have is that we have now swung to a degree where we are correctly focusing hard on how we prevent Enrons, but we are not focusing as effectively on the extent to which new regulations will impose costs, which in some instances may be excessive.

I'm concerned about two kinds of costs. Compliance costs under Sarbanes-Oxley mean something spectacularly different for small and medium cap firms than they do for large caps. Compliance costs for a large firm are trivial. They are easily part of the response one would assume a responsible board would engage in. But when you deal with the smaller and medium sized firms, particularly during difficult economic periods, Sarbanes-Oxley may deter firms from going public, may inspire more firms to go private, or may lead to a capital market which is not really in our national interest. The bigger issue, though, is that we have gone from the “Andy Fastow generation,” of people who didn't care about the rules and wanted to steam-roll over them, to a period where I worry that we will be so risk averse that we will have a less robust and less innovative economy than we should.

However, the whole picture is not just about costs. There are benefits to regulation and if you inspire more investor confidence and more investors are willing to invest or it's possible to restore an IPO market, one can link this to a sense that investors feel they are getting a fairer shake and a sense that the insiders aren't exploiting their position. The big question in securities regulation is, "How do you get the balance right?" We went from one pendulum swing—which in the late 1990s was wildly in favor of capital formation—to another one now where, at least with the smaller and mid cap firms and perhaps more generally when one focuses on risk aversion, we may have swung too far to the other direction. It will never be right permanently but I think it is something we always have to aim for.

PROFESSOR BAUMAN: You say we need to get the balance right. What is being balanced?

DEAN SELIGMAN: What you want is a form of securities regulation that doesn't occlude honest but risk-taking private business from initiating new products, from looking at new markets, and from being able to do what business does appropriately and well. At the same time you want mechanisms in place which deter fraud and deter the most excessive fiduciary abuses. It is easier to articulate it at the
conceptual level than it is to describe it in quantitative terms. What is wonderful about capital formation is one can measure profits and cash flows and how much money was raised and where the Dow Jones Industrial Average is. It is harder to have the same level of precision with fraud deterrence and it is very hard to identify "here's how you find the correct balance."

MR. WALLISON: In terms of preventing another Enron, I agree completely that the so-called gatekeepers were not perspicacious enough or didn't take action when they could have. But this is all hindsight on our part. We weren't sitting in their places, we didn't know what they thought was going on, and we now know that Enron and several of the other major cases were frauds. Even if the gatekeepers had begun to ask questions they might not have received truthful answers because the managements involved here were attempting to deceive. So the question is, "What can we do to prevent fraud?" The answer is, "Very, very little."

We ought to be focusing on disclosure. That's why I began my discussion by addressing GAAP financial statements; because what the S.E.C. could do most for investors is to warn them about the problems of GAAP financial statements and open up other areas where disclosure can at least cause analysts to question the financial condition or future prospects of a company. That is why I talked about cash flows. If you performed a cash flow analysis on Enron you would have seen that it was not throwing off any cash, even though it was purporting to earn great profits using GAAP.

So we need more disclosure, better disclosure, and a more independent group of analysts. One of the things we don't have in this country is a group of analysts who have an incentive to find these kinds of problems. We have short-sellers, but they are, unfortunately, few and far between and they themselves have an opportunity to manipulate the market. We have two kinds of analysts in this country: sell-side analysts who work for the securities firms that are in the business of selling stock, and the buy-side analysts who work for pension funds, mutual funds, and other institutional investors. Most sophisticated people would not want to trust sell-side analysts, for obvious reasons, and buy side analysts keep their opinions to themselves because those opinions are paid for by their employers, who don't want to let everyone else know why they are buying or selling a stock.

What we don't have is an independent group of analysts who can analyze companies, their cash flows, and their financial statements for the public. A few of these analysts do exist, such as the Motley Fool. But we ought to have a thriving industry of such people. The Internet can ultimately produce such a market because it is a mechanism for bringing together rather small payments at relatively low cost to create a profitable business in helping retail investors. But one of the problems is that there really isn't enough information available about companies to make this work effectively. Disclosure is the only way that we can prevent frauds in the future and frauds can only be discovered through careful analysis of financial and non-financial information about companies. We cannot do it by relying on the gatekeepers or the S.E.C.

PROFESSOR COX: We need to remove the corrupting incentives that killed Andersen. It was necessary to put that firm to death, because it had a terrible culture.
For example, it was the only major accounting firm in which a local office could overrule the central office's quality control on accounting metrics. That is an invitation for disaster. That is similar to giving a three year old a loaded pistol.

MR. WALLISON: We are allowing an anecdote to control the way we govern our entire financial system. Enron, which resulted in Arthur Andersen being put out of business, should not have been generalized into an argument that no gatekeeper ever performs his responsibilities. If you have worked with accountants, or served on the boards of directors, you have seen that the gatekeepers actually work very hard most of the time. In this case, that particular gatekeeper didn't. But that doesn't mean we ought to have put them out of business and it doesn't mean we needed an accounting oversight board in order to be absolutely sure that all accountant gatekeepers do their jobs.

PROFESSOR BAUMAN: I want to pick up on the disclosure question. Do you think that the new S.E.C. disclosure requirement is a useful answer or is it too early to tell?

DEAN SELIGMAN: The challenge is that you can't rely on any one mechanism alone. Disclosure is preferable to merit regulation. Disclosure is part of a mix. But unless there are mechanisms to enforce the disclosure standards, how successfully they will be complied with becomes very important. In terms of what Jim said earlier about Enron and the quality of disclosure, say in Footnote 16, which talked about related party transactions, my beginning corporation students are dumbfounded that anyone could have signed off on it. Of course, it didn't survive S.E.C. scrutiny. It was under a regime where the last time the S.E.C. did a full review of an Enron annual report was 1991. The last time it did a partial review of its financial statements was 1997. The disclosure standards, which actually were more than adequate, weren't being complied with and weren't being reviewed internally by the S.E.C. Therefore, they didn't trigger others, whether outside or inside of Enron, to blow a whistle until it was far too late. Peter would say that was an anecdote. You can say WorldCom, Tyco, Adelphia, and Global Crossings were all also just anecdotes. You can say 305 earnings restatements in 2001 are anecdotes. But at some point there seems to have been a fall in the enthusiasm for issuers to comply. There seems to have been a breakdown of what had long been a tradition in securities law where accountants and attorneys took it upon themselves to enforce the laws and put the fear of God in issuers or the board of directors: "If you don't comply, the S.E.C., the Justice Department may come after you." At some point, in a large number of cases, things broke down.

MR. WALLISON: My complaint is that we have criminal and civil laws that deal with the kinds of breakdowns that have occurred here. We have prosecutions—some of which are going on now. We see these people going before courts even today. We will see people from Enron, presumably when that thing gets unraveled and understood, going before judges and juries. That's how we deal with these issues. We deal with them afterward by punishing people who have perpetrated frauds. We shouldn't put in place mechanisms to try to discover all these things in advance because when we do that we create a system that prevents innovation, reduces incentives, causes people to be risk-averse, and imposes tremendous costs. We had a perfectly adequate system for punishing wrongdoing and we have not
thought to use it in this case. Instead we now have a placebo in place because Congress was concerned about the political ramifications of Enron and a few other companies. That placebo, which won't be effective in solving the real problems here, will cause adverse consequences for our economy for many years to come.

PROFESSOR BAUMAN: After listening to Joel, I don’t believe that more review would have been the answer. You need at least twice the staff to be able to do that. But apart from that, when the staff does its review, it doesn’t know when it looks at Enron that it is about to find an Enron scandal. So, does it approach its review with the idea that every single filing is potentially scandalous?

DEAN SELIGMAN: The whole notion of the S.E.C. mandatory disclosure system is to try to address problems before they become frauds. It's an ex ante system. The notion is that you file things with the S.E.C. through comment letters and through various other forms of review, you try to stop these fraudulent securities from getting to the marketplace. The problem with relying on enforcement after the fact, which we are doing now to a considerable degree, is that by that time it's too late. To prevent WorldCom practices earlier may have prevented a $200 billion drop in capitalization in that company alone. Also, it is thoroughly demoralizing to investors. To have story after story about these major frauds delays the enthusiasm of many for returning to the market and it persuades investors that the markets are crooked to a much greater extent than they are. Lastly, after-the-fact enforcement is far more expensive than before-the-fact deterrence. If you make it clear the S.E.C. is going to be tough, companies won't engage in funny practices, such as using SPEs. They will internally discipline themselves. If, however, you go through these lull periods where people don't really believe the S.E.C. is on the job, then we have this two-year to five-year hangover period that we are still in where you are cleaning up messes and to some degree having an adverse impact on the entire economy.

MR. WALLISON: The idea that the S.E.C. could prevent these kinds of things misleads investors into believing that when they make investments in the market, the investments they are making are safe. So, of course they're disappointed if something like this happens; in fact, they're outraged. Because we have led them to believe that we can stop these things through S.E.C. review. If we enlarge the size of the S.E.C. to several hundred thousand people and they went through financial statements, analyzed prospectuses, and asked questions, then over time we could probably prevent a lot of fraud simply by stopping activity and risk-taking. But I don’t believe that it would be sensible to do that.

PROFESSOR LANGEVOORT: I have a question for Jim Cox. It seems to me that if you are looking at the heuristics, you could criticize the S.E.C. for its enforcement process. One notable weakness is the tendency to regard any consent settlement against a company, even if it is nothing more than cease and desist, with no financial penalty against those who engineered the wrong, as a victory. The S.E.C. will trumpet a case against a Xerox or whomever, even though no serious penalty was visited on those who engineered the misconduct. One of the interesting things to do in evaluating S.E.C. enforcement would be to look at the basic cost-benefit question from the standpoint of those who were responsible for the fraud. What was the likely tradeoff between what they could reasonably expect to make from doing the wrong and what they ultimately had to pay in the S.E.C. enforcement
action? I suspect that on balance these were very profitable frauds even after the S.E.C. got finished cleaning up.

PROFESSOR COX: We didn't do that. We were mainly interested in tracking the profile of the issuers. I think that's a good idea. The S.E.C. was required by Sarbanes-Oxley to prepare a report of its enforcement actions over a five-year period. They reported on about 20 percent of their enforcement actions and we analyzed them. Out of the 20 percent of the enforcement actions that they collected, those involving what we were interested in, which were not 13(b)(2) books and records requirements, but rather financial frauds under 10(b) or 17(a), were a distinct minority of all the enforcement actions. Of those cases, only in a small number did you find an officer of a company who was himself or herself the target of the S.E.C. investigation. Although we all know that corporations don't do acts — it's individuals at corporations that do acts — too few individuals were the targets of S.E.C. fraud suits.

AUDIENCE MEMBER: I have a question for Peter Wallison which deals with his comments about independent directors joining boards. It seems to me that the educational process that they would need to go through would be very quick. They would get a briefing book of current issues and they would go to their first meeting and ask questions as independent directors. Do you agree with that?

MR. WALLISON: It depends on how much they are expected to know. To understand how a company operates is a lifetime project for many people because these companies, especially the bigger ones, are enormously complex organizations.

Let me just deal with the question of risk because that is where I think the rubber meets the road. In the past, before there was this sense of distrust of corporate managements, when a management proposed an acquisition or the building of a new plant or entering into a new product area, the directors asked intelligent questions as business people would under the circumstances. They asked whether management knows the company, has studied the market carefully, and we have to assume that they got it right and that the risks to the company are outweighed by the profits that the company can earn from making this acquisition, or whatever it is. Now, as a result of the fact that Sarbanes-Oxley is based on a distrust of management, and the independent directors know that they are on the board for this reason, that balance will shift. It will become much more likely that the independent directors, now a majority, will say, "Well, I'm not sure that we ought to be doing this." The result of that new power in the hands of an independent group on each hand is going to be much less growth in our economy.

PROFESSOR BAUMAN: Peter, why would the fact that there is greater stress on the role of independent directors necessarily mean that they start with the premise of distrust?

MR. WALLISON: This will happen because they know why they're there. They are there because they are supposed to watch management. Management did terrible things in Enron and WorldCom, etc. There isn't necessarily a connection between watching and distrust. But if you are there because you feel that
management is going to do something bad, then you are much more watchful and distrustful.

PROFESSOR ERNEST ENGLANDER (George Washington University Business School): I want to follow up on Professor Bauman's question, "how do you prevent future Enrons?" I would like to know if the panel believes that there are Enrons out there going on right now.

DEAN SELIGMAN: Every day you see new headlines about mutual fund research analysts and you keep seeing cases unwinding. Clearly in the past a good deal of this behavior has occurred. I don't think we will ever get to the point where you can eliminate all fraud. I do think you can reduce its incidence and its magnitude. I think that is now occurring to a significant degree. Are we right now preventing all Enron-like behavior from occurring? No, I don't think it's conceivable. But the extent of the dysfunction that we saw in the late 1990s has probably died down.

PROFESSOR ENGLANDER: Why did it occur and is there a need for any other sort of action?

DEAN SELIGMAN: The question boils down to a kind of cost-benefit analysis. We clearly want to reduce fraud as much as possible, consistent with an economy which can raise capital and be economically effective. But how you get the fulcrum correctly balanced is a complex issue. I agree with Peter that we could prevent virtually all auto accidents if we prevented all automobiles from driving more than 20 miles per hour. I don't think anybody would think that's a serious proposal. We can prevent virtually all fraud, but in so doing we might also prevent economic innovation and economic expansion. We certainly don't want to go that far.

MR. WALLISON: A better analogy might be to assume that we are talking about the automobile business and a company is making bad automobiles. We would not think that the government should establish a group to review the automobiles that are manufactured to see whether they are good or bad before they are allowed to be produced and distributed. We have someone that looks at these automobiles after they're in operation, but not before. Then we force the companies, if there is a safety-related concern, to recall them. But we don't try to do it before these things get into the hands of consumers. What the companies learn from what the Consumer Product Safety Commission helps them to improve their products.

The reason this analogy applies to our discussion is that shareholders have always had the power to control managements by selling shares. People have lost sight of this, especially in the S.E.C. If you want to leave a company, you just sell the shares. You don't have to pick up your family and move somewhere else. As a result, shareholders have tremendous power if they think that the company's poorly governed or that there is some other problem. By selling shares, the stock price goes down and it becomes much more expensive for the company to raise capital and options aren't worth as much, etc. I don't think we've paid enough attention to that.

PROFESSOR MARTINGINSBURG (Georgetown University Law Center):
I have the peculiar disadvantage of having been an independent director in a New York Stock Exchange company. It was a fairly sizable chemical company. Chemical companies are terrific but they can kill a lot of people. So safety is really important. I spent six years on the board. I chaired an independent board committee that handled safety, health, and the environment. I found that we not only could do a great deal to prevent killing the fish in Brazil and the natives in Australia, but that you could change the culture of the place, just through the independent directors taking it seriously and setting up procedures so that we had information coming back on a pretty current basis when things went wrong. In six years we took that company from being in the bottom quartile, in terms of environmental safety, to being in the top 10 percent. It was interesting because management, which had initially been unenthusiastic about this because their primary concern was making money, discovered that it really did help make money. People took a lot of pride in what they were doing and the management group shifted their attitudes as well. Independent directors can be gatekeepers if they want to do the work.

MR. WALLISON: I agree. I think independent directors have a tremendous amount of power. In the area that you're talking about, they helped the company and I think they can help in other areas, too. But my concern is that independent directors have a certain mind-set about risk and I think that is shifting the balance against taking risks.

PROFESSOR BAUMAN: Do you think that the view would be the same now after Sarbanes-Oxley? Do you think that the committee would function the same way?

PROFESSOR GINSBURG: In that particular company Sarbanes-Oxley probably would have had very little impact because it was a case where all of the directors were independent, except the CEO and CFO. All the committees were peopled by independent directors. There was probably a rather high degree of appetite for risks on that particular board. Part of this was due to the fact that one of the independent directors had been a very successful CEO of another chemical company.

PROFESSOR DALLAS: We've addressed the deterrence function of law, looking at the probability of getting caught and the profitability of crime, and really trying to analyze Sarbanes-Oxley in that context. But should we also look at the expressive function of law? What does Sarbanes-Oxley really say to people about norms and the way they should behave? After all, behavior is affected not only by the probability of getting caught but also by what is socially acceptable within the community. Do you think that the expressive function of law has changed in the last 10 years?

MR. WALLISON: There is tremendous expressive function in law, but it's adverse because what it expresses is that we should distrust management. The law began with the need for an independent audit committee. But the expressive function then worked to cause the New York Stock Exchange and NASDAQ to require independent boards of directors. What you're saying is correct; the law has had an effect because of the spirit that surrounds it rather than simply the words.
DEAN SELIGMAN: When you look at not only Sarbanes-Oxley, but at the expressive function of private, S.E.C., and Justice Department litigation, new standards from the major securities markets, etc., it is very striking that directors are now saying, "We don't want to have an Enron here. We have to take this much more seriously, in particular our compliance with audit standards. We have to focus on how we can prevent either a CEO or others within the company from pulling the wool over our eyes." At least in the short term, it has led to major behavioral changes. Corporate meetings take longer. The corporate books that are received before meetings are much more detailed. The expenditures on audit committees are significantly higher. The willingness of audit committees or boards to respond when an outside auditor says, "We see the following kind of problems" is clearly much greater. All of this is on the fraud deterrence side. The one caveat we always have to keep in mind is that to do this well, we have to get the balance right.

PROFESSOR COX: Sarbanes-Oxley stands as a glowing reminder and I hope that it lasts forever. It codifies what it means to be a professional, which is that you have public obligations. Every professional, be he a lawyer, an analyst, a reporter, or an accountant, now gets up in the morning and remembers that they have those obligations. They remember that they are bound by professionalism and that this is a duty that extends beyond their immediate clients, one that has far-reaching ramifications.
PANEL VI
INSTITUTIONAL INVESTORS AND THE RESTORATION OF TRUST IN FINANCIAL MARKETS

PROFESSOR DANIEL TARULLO: I don't think much introduction of Jack Bogle is necessary. Jack has become perhaps more prominent with the recent eruption of scandals in the mutual fund industry. We also have here Damon Silvers from the AFL-CIO. He brings the perspective of a different group of institutional investors, but a very important group to bear in mind. Also here with us is Stuart Gillan. He is on the faculty of the Finance Department and the College of Business and Economics at the University of Delaware. Before he returned to academia, Stuart had been a senior research fellow at the TIAA-CREF Institute. Prior to that, Stuart had been on the economic staff at the SEC and has also taught at the University of Hong Kong.

In looking for cures for what ails corporate governance in the United States, this conference has already looked at directors, managers, government, accountants, and market analysts. We now turn to the shareholders themselves. Today's institutional investors own half or more of the equity of the largest U.S. corporations. While they don't have controlling blocks of stock, they do have very different capacities from the individual shareholder who used to be the prototype for the analysis of the dispersed shareholder—the passive shareholder that we studied in the Corporations classes that most of us took in law school. To what degree will these different capacities offset the tendency of shareholders to exit rather than exercise a more activist governance role? Notwithstanding the potential, institutional investors have generally not played an active role in corporate governance. In some cases this may be because of legal impediments, but in other cases it is clearly from choice.

Today's panel will explore both the current and conceivable roles of institutional investors in corporate governance. Their comments will directly and indirectly address four kinds of questions.

First, what additional useful roles could institutional investors play in corporate governance? I emphasize "useful" as well as "additional." For example, the recent SEC proposal to permit significant shareholders to nominate directors upon certain triggering events is obviously an innovation, and I would be interested in hearing what the panelists think regarding the likely efficacy of that innovation.

Second, to what degree are these possible roles in the interest of the institutional investors themselves? Even if there is something which they may do which would help the corporation to be better run and therefore help all other shareholders, they may not assess the costs and benefits so as to decide it to be worthwhile to engage in that kind of activity. Are there differences among types of institutional investors which might lead some but not all institutions to be willing to participate, and to do so in special ways? Apparently, some institutional investors are more active in Europe than in the United States. Last week's Wall Street Journal had a story on Fidelity's active role in Europe as opposed to their relatively non-active role in voting their proxies in U.S. corporations; but why? Also, given
the current scandals in the mutual fund industry and the periodic problems in the pension fund industry, might institutional investors need to get their own houses in order before they try to solve the problems of corporate governance?

Third, how important are current legal impediments to the realization of whatever potential there may be for effective institutional shareholder activism that's also in the interest of the institutions themselves? Once again, the SEC proposal is a response to a set of perceived, existing impediments. But are there other securities laws issues, such as risks with insider trading or short-swing trading? Are there problems under ERISA, under the Investment Company Act of 1940, and under state corporate law?

Fourth, might there be negative, unintended consequences to greater institutional involvement in corporate governance? Might there be detrimental effects on non-institutional investors if institutional investors begin to play a favored role? For example, are some types of institutional investors more likely to take advantage of the SEC director nomination proposals? Might some institutional investors increase their laser-like focus on share price even more than corporate management, particularly if corporate management is deprived of stock options as a form of compensation?

PROFESSOR STUART GILLAN: I want to first give an overview of the institutions and institutional investors in the U.S. In the United States, institutions own on average 50 to 60 percent of many publicly traded corporations. But then the question arises, "Well, what is actually meant by 'institutional investor'"? There are different categorizations which we can apply, such as mutual funds, hedge funds, and pension funds. Within each of those categories we may have a number of different sub-classifications. For example, within pension funds we have public entities, such as CalPERS. We also have private entities, such as TIAA-CREF and the union pension funds.

Another means of classifying institutional investors is by whether they are active or passive. Look, for example, at some of the developments from index funds who follow the ultimate passive investment strategy. This is the approach adopted by and large at TIAA-CREF, yet this is one of the institutions that over the last 20 years has paradoxically become very active in corporate governance in the U.S. In terms of other types of active investors, we can compare the mutual funds, the stock pickers. There are still other types of groups or institutions that we might classify as operating in this space, such as leverage buy-out funds. These lie at the other end of the spectrum and are very much interested in participating in the market for corporate control.

So you can really think of institutional investors as falling on a continuum in terms of their activity and engagement in corporate America and corporate governance. At one extreme perhaps the most passive are those who simply buy and hold stock. A little further to the right on the line would be those who buy and sell. Further still are the institutions, many of which — given their fiduciary responsibility — are required actively to vote their proxies. We can move a little further and get to the institutions such as the AFL-CIO, TIAA-CREF, and CalPERS — institutions who monitor corporate performance and corporate governance and who have an approach
of entering into a dialogue with portfolio companies in order to seek improvements, not only in governance, but also ultimately in performance. A little further to the right on the line are the institutions who, in many cases, submit shareholder proposals to get a broader sense of voice on the issues at hand. We're seeing in process right now a situation where institutions going forward may be able to nominate directors and use the proxy mechanism in a new way. I would say that would be an intermediate step before the next point on the line, the proxy fight, running either a partial or a full slate of candidates for the board of directors at a company. Then at the very right of the scale are those institutions or players actively involved in buying and selling companies, replacing management teams, merging, acquiring, and taking them private.

We see a lot of different institutions engaged in all the activities along the continuum. In addition to focusing on the micro-level, the firm level, we also see a lot of institutions focusing on macro-issues or what I would perceive as regulatory issues. Again, the same types of institutions, often large publicly oriented institutions, weigh in on proposed regulatory reforms. You will very often see institutions such as Fidelity, TIAA-CREF, the union funds, and CalPERS offering submissions to the SEC on rule-making issues. You will see the same institutions offering submissions to the FASB when it engages in rule-making. You will see the same representatives on task forces of the New York Stock Exchange. I believe Herb Allison, the current head of TIAA-CREF, is on the board of the New York Stock Exchange. So in a very broad macro-perspective, these institutions are also very active.

At the end of the day, corporate governance comes down to the issue of conflicts of interest. These are agency problems, where the shareholders are the owners and the managers are the agents. Whenever you give your money to somebody else to look after it, there is always an issue of how well they are going to perform and there also are always inherent conflicts of interest in the system. What is interesting is that although we're talking a lot about corporate governance, there are also potential conflicts of interest within the fund industry itself.

Let me touch on the international perspective. The role of institutions internationally differs somewhat, depending on the particular environment. You have in many countries very different stages of economic development, both in terms of the economy as a whole and in terms of the financial markets. You have very different legal systems, which have different rules, regulations and constraints on what institutions can do. For example, in Europe there is a concept called "share blocking," whereby if an institution wants to vote its shares at the annual meeting, it must indicate its intention to vote those shares some number of days prior and it is then precluded from selling them through the annual meeting date. So in that sense there is a tradeoff between the ability to exercise voting power and a liquidity constraint to which the institution may not want to subject itself. In addition, European firms are largely dominated by what we would think of as a few, family-oriented large block owners. If you have a dominant controlling shareholder, is there a significant role for an institutional investor to play in affecting corporate governance? Despite the constraints, we are seeing more movement in corporate governance and shareholder activism in the international environment. Fidelity is involved in Europe and CalPERS has partnered with an activist European investment
fund called Hermes to buy up poorly governed and underperforming firms in Europe in order to improve their performance.

In the U.S., there are a number of legal constraints on institutions, not only in terms of the level of investment permitted in certain companies, based on diversification and prudent person rules, but also in terms of the nominations process and the possibility of having institutional director representatives on corporate boards. If an institution promotes an individual to be a director, it may by virtue of that designation become defined as an "insider." If the institution is an insider, there follow added constraints on its ability to buy and sell shares in the company. There's a tension, as Jack Coffee puts it, between liquidity and control. Regulation holds out other potential barriers as well. Regulation FD has been perceived to be a boon for the regular shareholder, but in some cases it is being used as a tool to deter dialogue with institutional investors. The institutions have gone to a company and said, "We would like to talk to you about your corporate governance and about your board structure." But the response is, "We can't talk to you because it would violate Regulation FD."

In sum, institutions are clearly important players in the capital markets. Are they part of the problem or part of the solution? I think they are both. It depends a little bit on the particular institution and the particular issue at hand.

MR. JACK BOGLE: I was intrigued by the theme of the conference, "Restoring Trust in America's Business Institutions." It wasn't so long ago that I read a quote from Chairman Donaldson, saying that his basic job was to restore trust. I thought that he was wrong. I don't think the job is to restore trust. I think the job is to restore integrity. If we do that, the rest will take care of itself. So today's issue is, where do institutional investors fit into this and how do they use their clout?

Let's start with the problems of trust, which to me arise from what has been described by William Pfaff, the journalist, as "a pathological mutation in capitalism" from owner's capitalism, where the basic idea is to provide a good return on the capital of those who provided it, to manager's capitalism. The corporation, quoting from Mr. Pfaff, "came to be run to profit its manager in complicity, if not in conspiracy, with accountants and the managers of other corporations." Why did it happen? He said it happened because the market has so diffused corporate ownership that no responsible owner exists. This is morally unacceptable, but this is also a corruption of capitalism itself.

I was a little disturbed when I heard that Sarbanes-Oxley was all about distrust in management. I don't think the issue is distrust in management. I think the issue is as simple as the separation of powers. As James Madison said, "If men were angels, no government would be necessary." I would say if chief executives were angels, no corporate governance would be necessary. Yet during the 1990s the whole system of governance broke down. I believe that too many boards simply failed to exercise their stewardship responsibilities to hold managements accountable, to make them represent the interest of their shareholders. When directors failed to fulfill that responsibility, the shareholders themselves didn't care enough to hold them accountable; and when the owners of corporate America don't care about governance, nobody should care about it. When the owners backed away,
the resulting power vacuum got filled by the corporate managers, proving that Spinoza was right when he said "nature abhors a vacuum." What we learned is that little good is likely to result when we erase the bright line that common sense tells us ought to exist between management and governance. But when we have strong managers, weak directors, and passive owners, don't be surprised when the looting begins. I want to be very clear that I don't think this is all the fault of a few bad apples, as has often been alleged. It's my opinion that the very barrel of capitalism which holds these apples, good and bad, has some serious problems and needs rehabilitation and that is where the institutional owners ought to come in.

How can we wake up the institutional investing community? It's not going to be easy. The financial ethos in our nation has turned from long-term investing, which could be described as a “stock owner” industry, to short-term speculators, which could be described as a “stock renter” industry. I was struck by a quote from Larry Sanders that I read in the Times yesterday morning. He said, "In all the recorded history of the world, there is no instance of anyone ever getting a rental car washed." By the same token, there may be no instance where stockholders who are renting stocks have any interest in participating in the voting process. The change in the industry is over time astonishing. We owned just 2 percent of all the stocks in America back in 1949. For 16 years thereafter, turnover in the mutual fund industry was 16 percent a year. The average fund held the average stock for six years. Last year, and in the preceding years as well, the turnover was in the range of 110 percent a year. This means that the average fund holds the average stock for 11 months. That is a shift from long-term investing to short-term speculation.

I should say that there is really no longer a useful distinction between the institutional investing community and the mutual fund community. They are very much the same. If you look at the 100 largest investment managers in the country, very few of them are not in both businesses. They’re almost all very large pension managers who have very small mutual funds or very large mutual fund managers who have small pension funds. They are pretty much all in the same industry run by the same people with the same investment ideas. So I would not be at all surprised that the pension fund turnover is very much along the same lines. The problem is that we have turned away from the eternal, intrinsic value of the corporation– which is reality—to a focus on the momentary and ephemeral price of a stock–which is perception.

It's interesting that my introduction to this business came back in 1949 when I read an article called “Big Money in Boston” in Fortune Magazine. Back then, we were called the “investment trust industry.” Think about that; they talked about trustees. The word "trusteeship" appears any number of times. We have moved a long way from that essential practice. Back in 1949 when I read that article we were active investors. Fortune wrote that "Mutual funds were the ideal champion of the small stockholder in conversations with corporate management, needling corporations on dividend policies, blocking mergers, and pitching in on proxy fights. This occurred even as the SEC was calling on mutual funds to serve the useful role of representatives of the great number of inarticulate and ineffective individual investors in corporations in which funds are interested." It just wasn't to be.

I had a little argument with Lord Keynes on this point. In Chapter 13 of The
General Theory of Employment, Interest and Money, he predicted that the uninformed public was just made up of speculators. He used the example of a beauty contest. He saw investors as a whole bunch of people trying to pick not the most beautiful woman, but the woman they thought the other voters in the contest would pick as the most beautiful person. He said it was only a matter of time until the professional investors followed the speculators and I had the temerity to disagree. I said that as the mutual fund industry grew, its approach to investing would be analytical, rational, and informed; it would focus on the intrinsic value of the corporation rather than the momentary price of its shares. I wrote that in 1951. Fifty-two years later the score is Lord Keynes one, Bogle zero. But the game's not over.

In terms of short-term speculation, you can see the law of unintended consequences at work. The huge drop in the cost of transactions and electronic communications has enabled investors to trade with great abandon. The total turnover costs are probably not all that much higher than they were years ago because we turned over faster at a much lower rate. The fact is no matter what the costs, short-term speculation is a loser's game. Gross return, minus the cost of speculation, equals net return. You lose to the market. In contrast, long-term investing, if you do it through a low-cost index fund—small plug here—is essentially a zero-sum game. So you've got a loser's game for the short-term speculator and a zero sum game for the long-term investor. The end game variations in returns are staggering. If anybody here doesn't believe that, just take a 9 percent market return rate and, for the students, compound it over your 50-year investment lifetime; call that the market return rate. Subtract 3 percentage points, which is about what mutual funds cost. Then compound the resultant 6 percent return over your investment lifetime, and look at the result. Long-term investing will produce around three and a half or four times as many dollars.

So I believe that index funds will continue to grow, as they are growing today, and will be required to find some sort of salvation. Index funds are probably about 15 percent of the marketplace today and they must be long-term investors. They cannot follow the Wall Street rule of “if you don't like the market, sell the stock.” We heard that in the previous panel. I think that's ridiculous. “Like it or lump it” strikes me as a very poor approach to public policy. Index funds have to like it because they can't sell the stock. So to ignore that and say that your choice is to get out irrespective of the price seems to me the worse possible direction. What we need is some kind of corporate democracy so investors are not put in that position. I have spoken a lot on these issues and I have been kind of a “Johnnie-One-Note” on this issue, although people are starting to listen.

We have drifted away from long-term investing and good corporate governance, which go hand-in-hand. We are now engaged in speculation and a nearly complete abandonment of governance standards. It is not a happy thing for the mutual fund industry, but it's all tied together. These scandals happen to be the tip of the iceberg in terms of the ghastly conflicts between managers and their owners. But in the long run, I think we all get salvation from using our clout. But determining how isn't easy. For what seems like 100 years I have been proposing the organization of a Federation of Long-Term Investors, beginning with index funds and including some of the other long-term investors that are out there. There's Bill
Miller at Legg Mason, the Capital Group, and many other investors who I believe are long-term and focused and I'm trying to get them together in some way. But they feel very conflicted. We, including Vanguard, are running pension plans and 401(k) plans for corporations. We are very nervous about taking them on in a governance sense, but we have to overcome that and start to vote as responsible corporate citizens.

To get this moving and to get this federation going, it will probably require a less outspoken leader than yours truly. But first, the fund industry has to have the guts to do it. Second, we need the motivation to do it. I think we are getting there in motivation, because we now have to disclose to our own shareholders how we vote the shares that they own through us. They are not our shares. Industry participants fought vigorously to keep us from disclosing to our own owners, our principals. We have been dragged kicking and screaming as an industry into the twenty-first century. Now that we vote and disclose our votes, we will have a motivation to vote intelligently. So now all we need is the ability to influence the corporations. We have already obtained a lot of relief on making business proposals, although I think we should get more formal relief. If we can do that, that will be a big help, particularly in the area of compensation. Third, we need the ability to nominate directors. The SEC is working on that. In my opinion, two or three years to do anything about a corporation is far too much time. I just hope that we develop some kind of a step system where if you can get investors together, say 20 or 30 percent aggregation of capital, they wouldn't have to wait for the first year's vote; they could just act. So we will then replace corporate dictatorship by managers and create a corporate democracy—or, at least, corporate republicanism.

The individual investors will dictate what the institutions do if they vote with their feet. I think ultimately the individuals will come to understand the power of long-term investing and abandon this fund industry's direction of short-term speculation and sector funds and so forth, considering the issues of cost. If we can get the owners in the driver's seat, I believe that they'll respond. Many of you say it will never happen. But it can happen and it absolutely will happen. Individual investors will not ignore their own economic interest forever. They might do it for another year, they might do it for my lifetime, and they might even do it for the lifetime of the youngest person in this room; but not forever. So this will happen and one day all will be well.

MR. DAMON SILVERS: Let me first begin by saying that I'm here on behalf of the 13 million families of the AFL-CIO unions, the working people whose retirement security is sort of the bottom line for institutional investors because our members are the beneficiaries. Unions sponsor a certain number of plans but the real interest of the labor movement is in the retirement security and the other financial objectives that all these plans ultimately provide. The labor movement's interest is also in the success of the corporate economy and the capital markets in delivering what they are ultimately supposed to deliver, which is not profit to investors. Profit to investors is a means to an end. The end is a successful and prosperous economy for all of us.

Some people say, "Well, the labor movement really shouldn't be mixing into this because these different objectives, the objective of funds, the objectives of
investors, and the ultimate objective I just talked about, are in conflict.” You hear that from the right and from the left, but that's not our view. We believe that you can organize things and you can behave in a way to put them in conflict. I don't think there is any question that the pursuit of shareholder value in the way the Enron executives were pursuing it was in conflict with the interest of our society, the interest of Enron's employees, and the interest of all the other investors in Enron. So there is no question that there are ways of pursuing investor value that are profoundly in conflict with the ultimate purposes of corporations and there are ways that are not.

I also want to take up the question that Dan posed to us about different types of institutional investors. Increasingly, when working people invest their retirement security, particularly in large pools of capital, the reality is that they can't do it in a profit-maximizing fashion over a long period of time by being an active trader, at least with most of the assets. Any sophisticated player in the business of managing money for workers' retirement security has figured this out. That is why CalPERS has 70 to 80 percent of its equity passively managed—it’s in index funds. They understand that they need to put a certain amount of it in active management to generate information in the marketplace and to provide benchmarks against which to measure the index. But most of its actual capital is passive. If you look at the big union sponsored funds, the Operating Engineers National Pension Fund, the various large Teamster funds, the Food and Commercial Worker Funds, all of them are doing the same thing. In fact, the Operating Engineers Fund equity investment is 99 percent indexed equity. Thus, most people's retirement security is bound up not in the markets, but in the totality of the economy, which is possible to invest in efficiently. We're not investing in mom and pop stores because we can't do it. But we are investing in pretty much everything else we can get into because that's what we have to do. We don't really have another option. The option of trying to do market timing or trying to beat the overall performance of our economy over time is a fool's errand. All you end up doing is generating fees for money managers, the highest paid people in the universe. It's just a waste of time and money. So increasingly those funds that are seriously focused on doing the right thing by their beneficiaries are long-term investors that are locked in.

I want to distinguish between two kinds of institutional investors. One kind is the investor who is basically investing in the economy for the long run. They may have certain slices in active management, both because it benefits the market systemically and because it helps them get a little bump on their return. But basically that group of investors is in it for the long run and is completely unable to take advantage of the Wall Street walk, even if they wanted to. The other kind includes the traders, those that are playing the market games, that think they have an information edge, that think they have the best computer, that think they have the smartest people, that think they can play the game of short-term trading. In my view, that is the critical distinction when you talk about institutional investors. Because those who are playing the market game, the short-term game, are going to have a different set of objectives and a different set of attitudes towards things like governance and a different set of attitudes towards ultimate purposes. Let's take a day trader, for example. If you are a day trader, you don't care what the ultimate impact on the society is of corporate conduct. You don't care whether or not corporations are ultimately adding to the wealth, prosperity, and well-being of our society. All you care about is whether or not you beat the spread this afternoon. On
the other hand, if you are buying everything and holding it for 40 years, you care an awful lot about these ultimate questions.

So how does this play out? When the market players say "corporate governance," they're interested in short-term plays of various kinds. They care about asset sales and whether they can force a dramatic move of some kind that can be arbitraged. They just want to bump the price here or there. Their attitude toward corporate governance has historically been focused on corporate control fights or in trying to force very specific moves that they think make sense in the short run. The institutions with the long-term perspective tend to be focused on things that sound a little bit more like "governance." They tend to be focused on whether or not the CEO is being watched. They care about whether executive compensation is properly aligned with their interest as long-term holders and whether the books of the company are accurate.

So, when you look at funds like CalPERS, you see that their shareholder proposals and their dialogues with management tend to be about those issues; and they have increasingly become about those issues as we have learned what our interests are. If you look at what our funds were doing 10 years ago it looked a lot more like a corporate control player model. We were interested in poison pills and the like. Today we're interested in things that make sense for the long-term investors, because we've learned who we are. I think that is a good paradigm for trying to make sense of the institutional investor. I think it's easier to understand if you look at the different types of objectives of different types of investors.

Then how do we make them effective? We believe that the long-term, broadly-held investor is not only going to act in its economic interest as a fund but is also likely to be more aligned with the long-term interest of the corporation. Given that the corporation is a contributor to the overall national well-being, we believe this is a very socially beneficial thing to happen. This also addresses a question that was raised at the beginning about unintended consequences and the broader impact of this activity. The big question that is on the table is “what are the mutual funds going to be?” There are some mutual funds that are at 100 percent or 200 percent annual turnover. There are some mutual funds that are indexes that are frozen. Then there is another problem, which is the conflict of interest. The inherent conflict of interest that we see with many mutual funds is that they are dependent on the very corporations that may potentially try to use them for 401(k) business, which is increasingly where the margin is. That buys silence. It bought silence for Enron and it buys silence for companies like Lockheed Martin that are protecting Enron-type people. The interesting thing about Europe is there is no 401(k) relationship. There isn't a giant contractor like Fidelity to run the pension plan of Daimler Benz.

So, what are mutual funds going to do? The labor movement fought very hard for mutual fund proxy disclosure because we believe that's the key thing. If our members know what mutual funds are actually doing with their proxies, they're going to behave better. Of course, if we really do get a critical mass of institutional investors acting in a long-term, responsible, and activist way, do we have the tools to affect corporate behavior? The Wall Street walk is not the right way to do it if you are an index fund, if you are a long-term holder. The right way to do it is through the corporate election process, through boards. We believe in boards. We take those
people seriously who said over the last 10 or 15 years that "corporate governance shouldn't be about the control market; it should be about boards." That's how we see it and thus we like to take a little credit for the SEC's proposal.

The SEC's proposal to give institutional investors access to the proxy for their own nominated candidates is the critical public policy reform that has happened since Enron. In our view, it is more important than Sarbanes-Oxley, if it's done right. Unfortunately, it's not done right in the initial version. It is too burdened with procedures and it's too long-term. But at least the commission has embraced the concept. Now it is incumbent upon us, the institutional investor community, to bring them around. We have heard in recent days some very harsh comments from the state treasurers and the state pension funds about how weak this is. I have confidence and hope that Donaldson, who has done something quite brave here, will see that if you are going to be brave you might as well be really brave. There is really no point to doing it halfway. Halfway will just get you caught in the crossfire between the business community, which will hate you for it anyway because they hate the concept, and the investor community and the press. He doesn't have to do that much; but if he improves it a little bit, we've got something real and revolutionary and something which plays into the kind of long-term, responsible investor activism that we believe benefits investors and all Americans.

PROFESSOR TARULLO: The SEC proposal is a great place to start our discussion. At the risk of oversimplification, and indeed imprecision, let me try to give the briefest of summaries of it. It essentially has three parts. First, there has got to be a triggering event in a proxy vote. This can be either that 35 percent or more of the votes have been withheld from a nominee of management or that 50 percent or more of the votes have been in favor of a 14a-8 proposal. Second, if the trigger is set off in a particular proxy year, then the next year shareholders accounting for 5 percent or more of the holdings of the class of stock that have held the stock for at least two years can designate, depending on the size of the board, one or more nominees to be included in the management's proxy materials. Third, there can't be a financial interest between the director and the nominating shareholder. The proposal, as Damon said, has been much-criticized. The SEC has taken refuge in the old motto that "if everyone is unhappy with us, we must have gotten it right." That saying is sometimes correct, but sometimes everybody is unhappy with something because it doesn't have much merit on any side.

PROFESSOR GILLAN: This is potentially a very powerful mechanism for shareholders. The regular shareholder proposal process is not binding. So if a shareholder proposal passes, management need not implement it. I have done a lot of work on shareholder voting. If you see a situation where 30 or 60 percent of the shareholders vote in favor of a shareholder proposal that is not endorsed by management, that's a very powerful signal that the shareholders are concerned with both the operations of the company and the particular issue. So having the ability to nominate external directors may have a great deal of potential. The flip-side is the issue of whether or not, as an unintended consequence, this is going to impose serious costs on large corporations. The devil is in the details of the rule that actually goes forward. The disclosure of funds' voting decisions may also play into this. One way this might happen is if the nominations process goes through and funds are required to disclose the way they vote; then there is going to be a metric to see what
they have been doing. Another unintended consequence that concerns me is the possibility that many of the institutional investors required to vote will delegate their voting authority to a third party. The predominant third party in this arena right now is Institutional Shareholder Services. So the question becomes “do we unintentionally delegate voting authority on all of these issues to a third-party service provider who not only provides voting recommendations to institutional investors but also provides corporate governance consulting services to corporations?”

PROFESSOR TARULLO: One important condition that I left out of my summary is that state law must permit shareholder nominations of directors. If the state corporate law forbids it or permits a corporation to have a bylaw which forbids it, then the rule would not apply. Jack, what would make the proposal more robust and more useful from your point of view?

MR. BOGLE: I have no problem with some of the thresholds. If institutional investors or shareholders who have owned the stock for two years only need to muster 5 percent of the vote, maybe the one-year delay before you really get down to the business of the day is okay. But just think about the amount of time involved. It probably ends up being a two-year process. If there is, in fact, looting going on, and certainly chief executive compensation is very close to looting in a lot of cases, in my judgment, you shouldn't have to wait two years to call the cops. So I think there ought to be an exemption from that triggering event if you can mass, say, 20 percent of shareholder votes that have been held by the same institution for two years. That's a pretty good size vote. Why should they have to wait for a triggering event? There may be even another level of thresholds, supposing it gets to 40 percent. All of this will get institutions talking to one another if they feel strongly about it. It will take some leadership, it will take a high profile, and, as I said in my remarks, a lot of guts to do it.

I am unconvinced that the costs to corporations are very large. They’re going to put three or four more names on the proxy and we will need a biography of each of the corporation's governance candidates and of each of the outside nominees. I don't see why the costs should be prohibitive. If you are in the mutual fund industry, you know that whenever someone doesn't like a proposal, they talk about costs—and these are from management companies. According to one account I read the other day, they have 56.1 percent pretax profit margin. The place for them to be worried about costs is not in the cost of SEC filings; it's in management fees.

PROFESSOR TARULLO: Damon, what kind of changes would the AFL like to see?

MR. SILVERS: We oppose the concept of triggers on principle. Our view is that if you have enough stock—say 5 percent of a large cap public company that thinks that someone ought to be nominated—that ought to be enough, period. However, we think that the basic concept of tiers that Jack was talking about is the right way to move this forward in a way that will actually do some credit to the Commission. We don’t agree with the whole notion that this right to nominate director candidates is so radical and exceptional; we see it as a fundamental thing. What we might want to see is a system where if you have 5 percent for your candidate, you're on; and if you have 3 percent, then you need to go through a
triggering event to get your majority vote.

What troubles us most about the SEC proposal in its current form is this: about 80 percent of the money that's invested in the market is invested in large cap companies, particularly the money that we care about—ordinary people's retirement savings. If you look at the history of shareholder proposals at large cap companies, there is a very limited universe of institutions that bring these proposals forward and none of them routinely own 1 percent of the company. The current triggering device, a majority vote on a 14a-8 proposal, has the additional requirement that the proposal’s sponsor must have 1 percent of the company's stock. But that never happens.

We want to address the fact that the current proposal involves a two-year period. By the end of this period, as Jack said, the looting is over. If we are trying to stop looting, that is a very foolish way to do it. Some say, "Well, that wouldn't have mattered to Enron, anyway. Nobody could have stopped it at Enron. It all went down the drain in a blink of an eye." That may be true but it would have made a great deal of difference at Tyco where there was a long period during which people were there who had no business running that company. That is the more common phenomenon. The companies that go down the drain in eight weeks are a lot rarer than the companies where there is a growing realization over a period of years that the wrong people are in charge. We are really concerned about two things: (1) there has got to be a way to short-circuit this thing so that you can move quicker; and (2) it's got to be constructed so that there is some ability in the real world for those institutions that are willing to step forward and take on these fights to actually do it. We need to begin the process with some thresholds that are low enough that a CalPERS could actually set things in motion by themselves without having to round up every other activist institutions in the country behind them.

PROFESSOR CHARLES O'KELLY (University of Georgia Law School): My question concerns the proposal. It seems that there is a camel in the tent, which is the fact that if the state allows a corporation to opt out of shareholder nominations, then that's the end of the game. I think many states would allow that. Also, the other reforms that would make shareholder democracy work, like “one share, one vote,” are blocked at the state level. Do you see any effort by the institutional investors to address that by federal legislation?

MR. SILVERS: I'm actually not worried about the state opt-out. Delaware used to be the subject of articles like “Is There a Race to the Bottom?” But over the past 15 years, it has become perceived as a relatively reasonable and fair jurisdiction. Having said that, I've got a list a yard long of things I don't like about Delaware corporation law, but that's not the point. The point is that there is a sense among institutional investors that you can go to court in Delaware and get a knowledgeable judge who at least on a good day is likely to be fair and you'll have a real chance of winning and that the statute there, compared to some other statutes, is actually not bad. It is deeply engrained in the legal culture of Delaware that there is an ultimate recourse by the shareholders to nominate their own directors. That does not mean that everyone in Delaware agrees with the SEC's proposal. But what it would take to defeat the SEC's proposal, in the way that you're thinking of, would be such a profound earthquake in the fundamentals of Delaware law that I just can't imagine
it happening. I also can't imagine companies running to some jurisdiction somewhere that would embrace it. Because to do so you would need to get shareholder approval and how would that happen?

PROFESSOR GILLAN: In Delaware, the judges are concerned with this tension between state law and federal law. It may be the case that cases under federal law will appear in front of the Delaware judges so that they will be left to interpret Sarbanes-Oxley. Then, there is another issue, and that is the “creeping federalization of corporate law.”

MR. SILVERS: If you don't mind I would like to address the question of a federal corporate law. The idea of a federal corporate law has been on some people's agenda for a very long time, going back to the New Deal. There is a very strong conceptual argument for a federal corporate law. The notion that corporations are creatures of just one state is really kind of farcical. But as a practical matter, were one to craft a federal corporate law today, the kind of law that you would get would be one that is considerably less advantageous to investors than, for example, the current corporate law of Maryland, which I believe is a far less favorable law for investors than that of Delaware. I think a federal corporation law today would be even worse. It is perhaps a sad comment on the state of Congress today that I'm far happier with the Delaware legislature and the Delaware bar at the moment than I am with what I believe would come out of Chairman Oxley's committee.

PROFESSOR BLAIR: I am very troubled by the idea of institutional investors becoming the monitors who make sure that corporations work well. We were worried yesterday about boards of directors, any member of which might be on as many as five boards, and whether they have enough time to really understand all of the things going on inside the company. This is despite the fact that they have access to inside information, to management, and to people down in the ranks. When you have an institutional investor that holds a whole portfolio, maybe with 10,000 corporations, how on earth can we expect them to be able to know enough to make intelligent decisions about what ought to be going on inside individual firms? Then there’s the question of who should serve on the board of that company.

Also, I wrote an article with Bernie Black and Sanjai Bhagat that was recently published. It tracked the performance of about 1,400 companies over eleven years and we were able to identify in those 1,400 companies every shareholder that held five percent or more of the company. So we identified companies that had long-term shareholders, meaning that they had someone that held 5 percent for at least three years. We analyzed that data thoroughly and we found no consistent evidence that having a long-term large shareholder makes any difference in performance one way or the other. My co-authors did another piece on independent directors and basically came to the same conclusion, finding that independent directors don't improve the performance.

PROFESSOR GILLAN: I'll start off with the academic response. It's true over the long term that the academic studies have a lot of trouble identifying a link between board structure and ownership structure and performance. There are chicken and egg issues regarding which causes which. That's part of the problem. But there is some evidence that active block holders make changes to corporate
value. There is also a lot of evidence to suggest that in the context of transactions—mergers and acquisitions and events of that nature—-independent directors appear to be associated with returns that are more favorable to shareholders. So I absolutely agree that over the longer term there is an issue from the empirical perspective. But over the shorter term, the transactional perspective is consistent with independent directors adding value or at least acting in the shareholder interest.

PROFESSOR BLAIR: But now you're saying it is the short-term shareholders that actually affect performance, not the long-term shareholders?

PROFESSOR GILLAN: Yes, but there is a tradeoff. If we find evidence that directors are acting in shareholders' interests in these circumstances, then should we presume automatically that they are not acting in shareholders' interests over the longer time period?

MR. BOGLE: The academic studies are okay as far as they go. I'm reminded of an event that happened when I was testifying down at the SEC when Arthur Levitt was trying to take public accountants out of the consulting business. The accountants said, "There's no smoking gun, there's no linkage between corporate fraud and the accounting firms being involved in consulting." But, as I said at the time, sometimes statistics don't prove what common sense makes clear. Statistics are pretty slippery things and sometimes you are dealing with pretty narrow parameters. I don't see how one can argue that the owners of the stock shouldn't take whatever responsibility they have and act the best they can. It's a very imperfect system. I'm going to guess that all of these blocks that people have talked about—the short-term holding periods, the limitations under the SEC rule, the public relations or business relationships that make it very difficult for mutual funds to participate actively in governance—are difficult. Maybe we need to push the notion that under some circumstances we should open the door to access and give people the right to nominate directors and make business proposals. Those notions themselves create better behavior by corporate managers, even if they are not acted on. Maybe just having the weapons there might be helpful.

PROFESSOR TARULLO: Why is this proposal so important to you? Why is potentially getting one director on a board such a watershed moment, which you clearly regard it as?

MR. SILVERS: The question of whether institutional investors know enough actively to play the monitoring role is a very fair question. I think you only really understand the seriousness of that question once you spend a little time inside a company. There really is a level of information that managers have that's simply inaccessible to outside parties. But if not long-term institutional investors, then who? In Europe, there are quite different answers to that question than we have here. But let's leave Europe aside for a moment.

If you think about the United States in the 1950s there were very serious constraints and oversight placed on corporate managers, but they were not primarily from investors. They were primarily from the government and the media, from labor unions representing employees, and from a number of other actors. But they were not oriented toward investment performance. They were saying, "You go out and
get investment performance and we will watch you and make sure that you don't do too much damage to the broader society." This was a very serious set of constraints. Those constraints are a lot weaker today. Look at the strength of the SEC in the 1960s compared to the SEC in 1990, it's pretty dramatic. The managers of America's large corporations in the early years of the SEC were terrified of the SEC in a way that they're not today. The concept of them as the investor’s advocate meant something. The balance of power between the state and the corporation was different. So you can envision trying to recreate that in some way, with some combination of governmental and social oversight of corporate leaders. But most people who say, "I'm not sure institutional investors are good enough to do this," aren't advocating that. They seem to be advocating nothing and we've just been through a nasty lesson in why "nothing" is not a good answer.

The question of access to proxy is the next question. Maybe it is not as much as it should be, but it's something. Corporate boards have learned a lot from Jay Lorsch at Harvard Business School, who is studying the sociology of corporate boards. The unity of the board is what business people say is the most important value. The most important thing a board should be is unified in support of the management division of the company. If the board is a battleground, it's going to be hard for the company to function adequately. But there are times when the unity of the board becomes the greatest threat to the company. We believe that large blocks of institutional investors have a pretty good chance of sorting out when that time is. The solution to the problem that occurs when the unity of the board becomes pathological is introducing not just independence, but an independent voice. In my opinion board independence is overrated. What we need is a little more accountability. A director has a very tangible sense of accountability to the shareholders who come in to take a new look, who may not have the majority of the votes, but who clearly have been sent to ask direct questions. The threat that such a person will arrive may be even more important than that person's arrival.

I also wonder whether the data in some way reflect the observation made in some earlier studies in governance that one thing by itself tends not to be dispositive; you have to look at a bunch of different governance factors together to get any kind of meaningful effect. Also, during the period of the data series you mention, the people who had the power were the marginal traders because of the link of the marginal trader's ability to set the stock price to the stock options, which was driving the CEO. It didn't really matter whether you had long-term holders or short-term holders, because those people weren't exercising any power. So it doesn't surprise me that it didn't matter because we didn't have the structures in place for it.

PROFESSOR JAMES FANTO (Brooklyn Law School): I have one additional proposal—maybe you could add to the SEC proposal that the director must be a lead director. Because it seems to me that right now the lead director is pretty much a sham. It's often an ex-CEO and it's supposed to be this source of opposition. So, maybe in your comment letter you could add that, if you don't think that is too controversial.

PROFESSOR GILLAN: I think there are a couple of things that we have to bear in mind. If you look back historically in terms of the market for corporate control, proxy fights are not that common. In addition, the number of proxy fights
where the candidates from the outside investor actually won is relatively small. Nevertheless, they can have a big influence in terms of changing the structure of the company. Even in recent, egregious cases of corporate governance, when alternative candidates were proposed, the dissidents have lost. The issue with this kind of mechanism is that you get everybody in the environment to think about the potential threat. So it is not so much the winning but the threat that has the power in this nomination process.

PROFESSOR TARULLO: Bob Posen, who has written a little paper on this set of issues, said he thought the single reform which was most likely to get institutional investors more active was the cumulative voting requirement, because it is relatively low in cost for the institutional investor but still potentially a big deal.

MR. BOGLE: I think we need cumulative voting to be much more important. I would love to know why the SEC didn't make the federal statute preempt the state statute; that would have saved a lot of trouble for us sitting around. I would be very interested to see what the Investment Company Institute does in its response to this pending proxy vote access issue, because they are really going to be torn. They are going to want to look responsible but they are going to hate the proposal because it is going to make the members more likely to vote. So a lot of funny things are going on, but I remain in the group that says just the threat will help.

MR. SILVERS: I think the key thing about the difference between the access to the proxy and cumulative voting has to do with costs. Cumulative voting really is about efficiency. With cumulative voting, a relatively small group of shareholders, say 15 percent, can elect a director, which is why it is distinctly unpopular for those who set the agenda at the annual meeting. But, when paired with the current proxy solicitation rules that the SEC has at any large cap company, it still requires a multi-million dollar effort by anyone seeking to successfully run a candidate.

Let me give you an example. I have priced what it costs to run an independent solicitation at AT&T. It costs a million dollars for one mailing, just the printing and the postage. If you want to win, you need to do two or three mailings, you need a phone bank, and then you have to fight at the SEC for weeks with very high priced lawyers to get your material through. So you are talking about a three or five million dollar proposition to win at a large cap company under the current rules. There is no institutional investor today, particularly anyone governed by ERISA, prepared to eat the collective action problem around that kind of price. With the access to the proxy rules, the cost just went down to about $10,000, and that is a cost that a lot of people are prepared to eat. So, combining the two is very powerful. That is a fight in the trenches, though. That is a fight company by company or state by state to achieve that.

Then, there’s the question that Jack raises about why we don’t get back to federal corporate law and preempt this question. I think that the commission feels that it would be pushing the envelope in terms of the powers delegated to it under the 1934 Act if it were to say, "In order to be a public company you must have cumulative voting." There are some spurious federalism issues that have been raised around the access to the proxy. I don't know of anybody serious who thinks those issues are real. However, I think that an SEC effort by regulatory action to mandate
nationally cumulative voting for all public companies would probably raise a serious preemption issue.

PROFESSOR FISCH: This question follows up on the issue of mutual fund involvement. Several of you talked about some of the reasons mutual funds haven't been active in the past. The cost issue still seems to me to be a major obstacle, putting aside the business relationship and all of that. Is it ever going to make economic sense for somebody like Vanguard, given that it's looking to keep its management fees at a very minimal level, to make the effort of aggregating investors and identifying good director candidates, getting the legal advice, and getting involved in the process? We have seen what mutual funds have done respecting voting. The voting decision is either too risky or too expensive to get involved in, so they delegate it. Is cost a major obstacle and, if it is, are there other things that we could do to address that problem?

MR. BOGLE: I don't believe cost is a major issue. I have heard that TIAA-CREF, which is the activist champion, takes on 15 companies a year, usually smaller companies. Yet I believe the cost of their activist effort is something like a million dollars. I don't know what Vanguard is spending today but we have a small staff that actually does the proxies and we'll vote against option plans that are excessive. We have a whole set of guidelines; we're not aggressive voters, but we're not entirely passive either. We can vote in a considered way and the cost of that is not large at all.

However, a big problem arises when an institution spends a lot of money in this area. What does it do when it has great success and the bad guys are thrown out and the new guys come in and the corporation is worth a lot more and the institution’s competitors benefit from that in the exact same proportion that it does? If the competitors own more stock, they benefit more than the institution did at no cost at all. I don't quite know what to do about that except in a better world you would think that an institution called the Federation of Long-Term Investors could get together, fund itself and therefore the benefits would flow out to everybody else.

I am deeply concerned about what’s in the previous bill on mutual fund proxy voting disclosure, which allows you to delegate your fiduciary duty to an outside agent who can vote. That sounds to me like a parent saying, "You can have my child if you want." It doesn't seem like good parental responsibility to give your child away to somebody else. I’m also troubled about the conflicts of interest at ISS. What we need is a real grown-up, mature, thoughtful, and unconflicted ISS that will compete in the marketplace, with the ability to follow up on the regulation which is already there.
PANEL VII
ADVOCATES, COUNSELORS, AND GATEKEEPERS: THE ROLE OF LAWYERS IN THE CORPORATION

PROFESSOR MILTON REGAN: Let me mention who we have on the panel. To my immediate right is my colleague Neal Katyal, who is one of the leading scholars in criminal law. Paul Saunders is a partner at Cravath, Swaine & Moore in New York. He also teaches a course here called “Corporations Under Fire.” He has been involved in numerous corporate investigations and litigations. Jack Coffee is a professor at Columbia Law School. He is one of the country’s most eminent scholars on securities law as well as on matters of corporate governance. Chuck Davidow is a partner at Wilmer, Cutler. He has been involved in some of the major internal investigations in recent years, such as the Powers report to the Enron board of directors, the report to the WorldCom Board, and various other matters. Finally John Villa is with Williams & Connolly. He also has a distinguished record in both litigation and investigation. He is currently representing the law firm of Vincent & Elkins in the Enron litigation. John also teaches a course here entitled “Counseling Corporations in Crisis.”

The broad focus of the discussion today is going to be on what kinds of legal measures might help promote corporate legal compliance. To what extent are those measures complementary, and to what extent are they in tension? What are the implications and consequences of relying on one approach as opposed to another? To what extent can less formal norms do some work where the law can’t?

We’re going to organize the discussion around three broad topics. First of all, we’re going to look at some of the enhanced legal liability that has been established as a result of Sarbanes-Oxley and other legislation and discuss its likely consequences. Second, we’re going to look at corporate legal compliance programs and their treatment under the law, particularly under the organizational sentencing guidelines. Finally, we’re going to talk about the extent to which professionals such as lawyers and auditors might serve as gatekeepers in helping prevent illegal activity. What kind of legal exposure might such professionals have with respect to corporate misconduct?

Let me begin first with a very brief description of what the Sarbanes-Oxley legislation has done with respect to criminal penalties. It doubled the maximum prison term for securities fraud to 20 years. It quadrupled the maximum term for mail and wire fraud from five to 20 years, 30 years if the crime affects a financial institution. And it has created a new securities fraud offense with a 25-year maximum term. The first question is to what extent these provisions are likely to affect corporate behavior?

I’d like to start off on a broad conceptual plane and then move more to the perspective of those in the trenches. My colleague Neal Katyal has written on the issue of the extent to which the criminal law can be used for purposes of deterrence. Neal, what kinds of things do we need to be thinking about when we consider the potential deterrent effect of measures such as these?
PROFESSOR NEAL KATYAL: Well, most of my work is on street crime, unlike the rest of the panelists, so I will be brief and listen more to what they have to say on this topic.

In general, this is an area in which deterrence does work a lot better than in the street context because you have knowledgeable players who are worried about their reputations, who are advised by expert counsel about what the law is, and who are also repeat players in the game of business. Because of that, theoretically there could be more deterrence in this context than in other criminal settings. That said, the penalties that Sarbanes-Oxley imposes aren’t likely, in my view, to do all that much for a couple of reasons. One is that criminal scholars basically identify two variables here: the probability of getting caught and the sanction imposed by the law. Sarbanes-Oxley ratchets up the sanction, quadruples or doubles, depending on the particular crime, but the legislation itself doesn’t do much with respect to the probabilities of enforcement.

The empirical literature on street crime suggests that the probability of enforcement is significant and I think there are a couple of reasons to think that it would matter even more in this context for business executives. People care about their reputations. The idea that someone is going to say, “Oh well, I’m going to cook the books if the penalty is 10 years but not if it is 20 years” is, I think, probably a calculation that few people are going to make. They’re not going to approach things in this way. Rather, they are likely to be asking, “Am I going to get caught for this crime or not? What is the likelihood of getting caught?”

The other issue that you have to think about when you ratchet up sanctions this high is the inverse sentencing effect. This is the tendency when sanctions get too high for people not to turn others in. Much enforcement attention focuses on getting whistle blowers to talk and the ombudspersons to be warned about what the corporation is doing. If you ratchet sanctions up to this very high level you may get people who are afraid to talk because they don’t want to turn their friends in for 20-year sentences.

Now, that said, why are we going down this road of Sarbanes-Oxley and ratcheting up the penalties? The answer is obvious. It’s a lot cheaper than actually enforcing the existing laws out there.

When England in the 18th century couldn’t collect taxes, what it did was to punish crime severely. For instance, it imposed the death penalty on a variety of crimes, including relatively minor ones such as stealing a deer. The truth was, very few people actually got the death penalty. It was the high sanction that was thought to provide some deterrence. You get greater deterrence if you invest more resources in the probability of getting caught, but it costs more.

The last conceptual point I’ll make is this argument about gatekeeper liability—which we will focus on a little bit later in the panel—and whether something is occurring more generally in criminal law. The worry is that you can’t always get at the end users. Consider for instance, music downloading. It is hard to find the people who are downloading the copyrighted music. So instead, you go after the Internet service providers like Verizon or you go after the software makers like
Napster, the authors of the code. You're worried about drug dealing in apartments and it's hard to find out who those drug dealers are, so you punish landlords, as federal law does, who knowingly rent their apartments to drug dealers, and so on. This is a broader move being made in criminal law generally and gatekeeper liability raises many issues, which I’m sure we will discuss.

PROFESSOR REGAN: Thank you, Neal. Paul, Chuck, and John, you have clients who potentially may be facing these sorts of penalties. What's your sense of the likely impact of this increase in criminal penalties?

MR. PAUL SAUNDERS: I agree with most of what Neal said. I think you need to distinguish first liability for the organization and the penalties that can be imposed against the organization on the one hand, and liabilities or penalties that can be imposed on individuals on the other. I think they are really quite different and they are perceived to be quite different.

I think it’s too early to tell what the effect of the increased sentencing will be. There have been so few criminal cases brought against individuals that it's really hard to tell, hard to make any prediction as to how the increased sentences will affect corporate behavior.

My own view is that a greater deterrent for corporate misbehavior in the past has been the threat of private litigation because that is much more likely to come to pass. You can pick up today's Wall Street Journal and you will know almost to a certainty which corporations are going to be sued tomorrow. That's not true with respect to criminal liability or criminal investigations, which have been far less certain. They are not very high on the radar screen of corporate executives, who are not so much worried about criminal liability. You rarely find somebody who says, “Gee, if I recognize revenue from this contract today, instead of following GAAP and wait until tomorrow, it will be a felony.”

With respect to individuals, I think that the jury is still out. The sentences are very, very high, and the sentencing guidelines now provide for enhancement of a sentence for corporate misbehavior. Securities law violations are very, very high, almost off-the-charts high. So it remains to be seen, I think, what the effect of that is going to be on individual corporate behavior.

PROFESSOR REGAN: Paul, before we move on to Chuck and John, let me ask you, is the real concern in the criminal context less the penalty than it is the likelihood of indictment itself because of reputational concerns?

MR. SAUNDERS: In my limited experience, criminal considerations have been rare except in cases of blatant misconduct such as embezzlement or shipping bricks as disk drives. Most of the corporate misconduct we are talking about today, however, starts with baby steps and doesn't start with huge, giant conspiracies to cook the books.

At least in the beginning stages of this misconduct, people don't think of what they're doing as having criminal consequences. It just doesn't occur to people to say,
“Gee, if I don't follow GAAP, I'm going to go to jail.” So it is not very high, in my experience, on people's radar screens.

MR. CHARLES DAVIDOW: If I can jump in, I agree with Paul, both in terms of the effect of increasing the sentences as well as what it is that gives rise to misconduct. I don't see the increase in sentences as having any consequence at all with respect to deterrence. Prosecutors know how to choose which charges to bring, how many of them to bring, and so forth, so that the exposure to a very large sentence has always been there and will continue to be there. A knowledgeable corporate officer contemplating engaging in a crime before these increases already faced more than adequate deterrence.

The problem, as Paul says, is that with most of the scandals that we're talking about now, people didn't think of themselves as criminals and still don't. When they think of criminals they are thinking about perhaps the people who are running boiler rooms, or more likely thinking of the people who go and knock over banks.

One of the big things that the recent events have done is bring to the attention of people who might be engaging in even those first baby steps that they may be starting down the road to something that may be a crime. Both inside counsel and outside counsel now have considerable leverage in saying, even if it is in a half joking way, “Doing this kind of thing, how would you like being where Andy Fastow is now?” The gradually growing notion that these things really may be criminal, and awareness that it may actually be appealing for the authorities to bring prosecutions may well have a significant impact.

This isn't to say that I think it was wrong for Sarbanes-Oxley to increase criminal sentences because an objective apart from deterrence is expressing society's view of the just sanctions for a crime. One can argue and debate what level of sanctions accomplishes this. That, however, is a matter entirely separate from concern about deterrence. I think the desire to express more serious disapproval did play a role in the Sarbanes-Oxley sentencing increases.

MR. JOHN VILLA: I look at it from a slightly different perspective. I think that the perception of mid-level employees and junior officers in many corporations today is that they are much more vulnerable than they were three years ago. The perception is that more whistle blowers are coming forward, more people are questioning corporate conduct to try to avoid personal sanctions for themselves, and more are refusing to sign things, or to take certain actions.

I believe that people who are involved in overseeing conduct have to conclude that next year the chances that somebody from their unit is going to go out and publicly question the conduct or the accounting or the manner of the transactions or their business purposes is much higher than it was three years ago. So I think there is an indirect effect of the new law enforcement push into corporate America.

If you look at the S&L wars that started in 1984 and ended not more than a couple of years ago, the increased sanctions really didn't have much effect on the people who were conducting the supposed scams of the savings and loans. It was really a dramatic increase in the prosecution of mid-level people and others that
forced these things to come out.

So I think that you are going see an increase in corporate compliance, if you will, by law enforcement pressure. I think there is a real social cost to that because I think some people are just simply being singled out and very harsh sanctions imposed upon them. But I think you are going to see an increase in corporate compliance.

PROFESSOR JOHN COFFEE: Let me add just one word. Many, many years ago, I served as a reporter for the American Bar Association for its sentencing alternatives and procedures. It was a non-corporate assignment, but I actually taught a course in sentencing back in those early years. In the course of being the reporter for the American Bar Association, we adopted model standards on sentencing alternatives and procedures only after much, much negotiation, much hair pulling, much yelling by prosecutors and defense counsel. We got an agreement on the standard, which I think is still the ABA standard in theory, that a sentence in excess of 10 years should only be imposed in the case of an exceptionally dangerous criminal who commits an exceptionally culpable offense. In other words, for most offenses 10 years should be the maximum ceiling.

Now, after a scandal we get the usual election year response and we're talking about 30 years and 25 years. I think if we talk about actual time served, 10 years should be seen as the normal ceiling, unless we are dealing with recidivists or perhaps people who have committed capital offenses. I also think that the system would work much faster with lower sentences. My guess is that if prosecutors were giving Mr. Fastow the chance to plead guilty to five, six or seven years this would all be over, he would be in prison and he would be testifying against higher-ups. When they start the negotiation with a minimum sentence of 10 years, it's going to take that time until we get to the end of this ladder and the last domino falls somewhere in the direction of the chief executive officer. And who knows whether we will all wait that long and be around at that point.

So there is, I think, a real problem with that kind of exemplary sentence and I think it is essentially an election year solution to crime. And election year solutions don't usually work that well. And I agree with the point earlier, which I think has been the consensus of criminologists since the time of Cesare Beccaria, that the certainty of detection is far more important than the severity of the sanction.

PROFESSOR REGAN: Let me follow up with a question on charges against corporations as entities. The Department of Justice guidelines came out a little while back. Eric Holder first promulgated them. Larry Thompson revised them earlier this year. They have been controversial with respect to an emphasis on the importance of corporate cooperation, and in particular regarding willingness to waive the attorney/client privilege in a corporate context.

How is that playing out in practice? Are there reasons to be alarmed? Certainly, the defense bar has voiced very strong criticism of this. What is your sense of that?

MR. SAUNDERS: In my experience the SEC has actually been better than
the Department of Justice in insisting on waivers. The SEC is really pretty good. They rarely will insist on a waiver. In my experience they never insist on a blanket waiver. The Department of Justice, on the other hand, will on occasion insist on a waiver. This raises this whole issue of the protection that might be given to an internal investigation.

What the SEC and especially the Department of Justice love to do is get inside lawyers’ heads. If they know you have done an internal investigation and that you did not make it public, which you typically would not do unless the corporation was in bankruptcy, then they want to see it.

And the concern about a waiver is the use of material in private litigation. If you waive the privileges and produce documents to the Department of Justice or the SEC, the real concern is that you may waive the privilege with respect to private class action litigation where there is real money at stake.

Now, the SEC has proposed legislation that would provide that turning documents over to the SEC does not constitute a waiver. And there are a couple of cases that suggest that if you do it the right way, you may not waive the privilege if you produce documents to the United States Attorney under a confidentiality agreement. But it still is a huge risk. And, in my experience, prosecutors will ask you to waive the privilege. This often is a major problem and major difficulty for practitioners.

MR. DAVIDOW: I have run into this issue a number of times as well. In both the Enron and WorldCom investigations the companies did agree to provide the work that we had done to the government and ultimately to the public as well. The government generally does request that, and the amount of pressure that it exerts varies from case to case. As Paul suggested, the U.S. Attorneys Offices have been much more aggressive, although they become involved in a small percentage of situations. The SEC, in some cases, has been quite aggressive and in others much less so.

As Paul says, it does raise a privilege waiver issue. The courts are now all over the lot as to whether it can be viewed as only a limited waiver or whether it also extends to private litigation. One issue, of course, is the consequences to the company of private litigation. But it seems to me the harder issue is the consequences of that kind of waiver on the willingness of other companies and other officers and other boards and committees to involve counsel in the sort of way that most of us feel is beneficial for them to do. And those are hard questions. It’s very hard to evaluate overall.

Once a crisis emerges the board typically will do whatever the government demands that it do. It’s the rare board that’s prepared to say, “No, I think the consequences down the road or the consequences to companies other than ours are sufficiently great that we are prepared to say no to the government now.” So there is enormous pressure to go ahead and do it. And it’s a difficult question to answer whether in the end it’s better to have these waivers and get the information out and not protect those who don’t deserve protecting, or whether having less information readily available in a particular case is justified because the companies get a more
secure environment in which to seek the advice of counsel.

PROFESSOR REGAN: Chuck, let me just jump in here for a minute and play devil's advocate in a way that I suspect will be unpopular with several members of the panel.

One rejoinder to the concern that has been articulated about discouraging internal investigations and involving counsel in them is that a corporation really can't afford not to do that. That is, there are lots of incentives for corporations to do thorough internal investigations involving lawyers so they can genuinely get to the bottom of what's going on. The argument has been that there is very little likelihood, therefore, that the prospect of losing the privilege will act as a significant disincentive. I've heard even some inside counsel say that. So what about that sort of rejoinder?

MR. DAVIDOW: My quick reaction is in the case like an Enron or a WorldCom I think that's absolutely right. The board will be faced with an imperative that it conduct an internal investigation. However, there are a lot of much smaller and much narrower situations in which the decision is not nearly so easy and the choice may be more difficult.

PROFESSOR COFFEE: I think there is an even more subversive point in the idea that you just raised. We're having a debate now over the proposed noisy withdrawal rules. The claim made by the bar is if you were to adopt a noisy withdrawal standard then corporate officials would never confide in counsel because they know that counsel might, either voluntarily or under duress, reveal this to the regulator or to the U.S. Attorney.

I think it's already the case that, because of the prevalence of the SEC in these investigations and the fact that the SEC will at least be regularly seeking some form of waiver of privilege, no corporate officer today can really confide in corporate counsel with a strong expectation that privilege will be protected. It is the corporation's privilege and the corporation will waive it in the corporation's own interest, which can often conflict with the officer's own interest. Therefore we are dealing with a fairly permeable privilege and, I think, it is all a relative question. And noisy withdrawal is something that involves a balancing of these issues, but they are already there and there is no such thing as an ironclad privilege anymore.

PROFESSOR REGAN: Certainly there are a number of exceptions to it that apply. And there is some empirical research out there that suggests that corporate officials, in fact, are not especially knowledgeable about the contours of the privilege, suggesting that perhaps concerns about it may not provide a significant incentive for them.

I was going to move to noisy withdrawal a little bit later, but since Jack put it on the table, let me first just describe what the proposal was originally by the SEC, which has been withdrawn, and then solicit some comments from the members of the panel. The SEC proposed originally in its rule-making pursuant to authority under Sarbanes-Oxley that when an attorney reports evidence of a material violation of securities law, breach of fiduciary duty or what is called “other similar
violation”—we’ll get to that momentarily—and does not receive an appropriate response from higher-ups that the outside counsel must resign from the representation and must notify both the company as well as the SEC that the resignation is for professional reasons. The attorney also must disaffirm any work product that has been submitted to the Commission that he believes is materially false or misleading in light of the information that he has. With respect to inside counsel, the proposal was that inside counsel must notify the SEC within a day that she intends to disaffirm the work product submitted to the Commission that she believes is materially false or misleading.

That generated tremendous controversy, I think, it's fair to say. The SEC has proposed an alternative, which is that the company, rather than the attorney, make the disclosure to the SEC about the resignation and the reason for it. Given what Jack has said about some of the countervailing concerns, how serious a state of affairs would it be if the SEC revisited this and actually did introduce a noisy withdrawal rule?

MR. SAUNDERS: I think it would be disastrous. The relationship between a lawyer and a client is fundamentally one of confidentiality. I know a lot of things about my clients over the years that are not public. I can't really do my job effectively and I can't counsel my clients effectively without that confidentiality. But we have seen over the years that government regulators don't like that confidentiality. They constantly want to get inside the heads of the lawyers who have information that they don't have.

Those of us who have litigated privilege issues for many, many years have seen that the attorney/client privilege is very fragile to begin with. If you start imposing a noisy withdrawal obligation on lawyers, first of all, it will be obvious to everybody why you are withdrawing because of a problem. Second, it really is going to affect, I think, the independent role of lawyers in giving confidential advice to their clients. I think it is a very bad idea. I think we will hear more about it.

It's not dissimilar from the Department of Justice guidelines that give you credit for waiving the attorney/client privilege or the SEC guidelines that give you credit for waiving attorney/client privilege.

PROFESSOR KATYAL: I disagree with what Paul is saying. I think his position reflects a little bit of a myth about what lawyers do and that it also understates the lawyer's incentive. Lawyers already are subject to the crime – fraud exception; they're subject to “aiding and abetting” liability when they knowingly file false statements and so on. This idea that the lawyers have absolute confidentiality and that's central to the relationship, well, there already are a number of exceptions.

But I think the harder point for Paul to deal with is the one that Jack was getting at in his last remarks, which is that there are already any number of incentives for clients at least ex ante to approach their lawyers and disclose things to them. It is really the ex post situations – when someone has already engaged in misconduct—in which you are going to have the chilling effect. And it is not clear, to me at least, why we should value the attorney/client confidentiality relationship ex post to the same extent we do ex ante. That is, if we want to celebrate the idea of lawyers as
advising clients to steer away from dangerous actions, it makes sense to have pure confidentiality in the early stages before the action has occurred, but why should we so celebrate it afterwards?

MR. SAUNDERS: Let’s take the case of a criminal lawyer who’s representing a criminal defendant and that criminal defendant confides in the lawyer. That’s *ex post*, right?

PROFESSOR KATYAL: Yes.

MR. SAUNDERS: We shouldn’t protect that communication?

PROFESSOR KATYAL: Well, we shouldn’t protect it to the point where if there is a confidence, for example, that “I’m going to commit this particular fraud” or “I have committed this crime” and then that person is going to go on the stand.

MR. SAUNDERS: But that’s too easy. We know those exceptions and we have known those exceptions for 30 years. Take the other problem, where the lawyer knows that the client did, in fact, do something wrong. You think the lawyer should have an obligation to disclose that fact?

PROFESSOR COFFEE: No one is proposing that under the noisy withdrawal rule. All that has been proposed is such withdrawal if there is a material violation that is, (a) continuing and, (b) that threatens serious injury to the security holders of the company. In your hypothetical situation we are dealing with all past conduct, there is no continuing violation. And no one is challenging the attorney/client privilege.

MR. SAUNDERS: But is it *ex post*, to pick up Neal’s point?

PROFESSOR REGAN: John, I think you were going to jump in.

MR. VILLA: Well, I wanted to make a couple of observations. First of all, I don't know if you have seen the report of the Ad Hoc Committee on Corporate Sentencing. It came out about a month ago. I think they surveyed 57 U.S. attorneys’ offices of which 42 responded. It was a very interesting report because it talked about the number of times in the United States where the U.S. attorneys’ offices had demanded a waiver of the corporate attorney/client privilege and the number was something like 12 nationwide. It was pretty shocking.

MR. SAUNDERS: Yes, but is that for all investigations or just convictions?

MR. VILLA: This is waiver of attorney/client privilege of corporations in the context of sentencing. The essence of the report was that the shadow of this is much larger than the reality. And there are many jurisdictions where it has never happened at all. In the Southern District of New York it happens probably more often than any place else, but it doesn't generally happen.

Secondly, I would say that in most of the circumstances I wouldn't be as concerned about the noisy withdrawal because the issue is: When do you get to that
point? Most lawyers don't get to that point. They have many, many options prior to that time of getting out of that relationship.

I think that the issues that most trouble lawyers, speaking as one that spends a lot of time counseling lawyers and defending lawyers, lie in the gray area involving questions such as: Is this an accurate disclosure? Is it not an accurate disclosure? Is it GAAP? Is it not GAAP? Is GAAP good enough? Is GAAP not good enough? There are many areas where I don't think that lawyers can reasonably come to the conclusion under today's law, unless they have a crystal ball, as to whether or not the conduct is illegal. And I think those are the areas that are driving lawyers crazy, much more than the notion that “If I come to the conclusion that my client is engaged in wrongdoing do I have to rat him out?” Because most people don't get there. And I think that's the area where I find it most troubling for lawyers.

I don't do much counseling of corporations, fortunately. I mostly pick up the pieces after litigation has started, and the lawyers are in trouble or the corporations are in trouble.

But I find it very difficult to figure out how you do your job when you really have two jobs. One of them is to try to talk to the corporation and lead them through this gray area and the other one is to try to worry about how everything is going to be seen in hindsight. If there are certain facts out there, which you're not aware of, which could change the whole picture and two years later everybody is going to look at it as some massive fraud, how are you going to protect yourself? I think that's what is happening in today's world and it is eroding the position of the lawyer as being an objective, true advocate for his client and an unbiased counselor. But that is what we want in our society. We believe that lawyers are fundamentally more honest than businessmen –I think that is what is reflected in Sarbanes-Oxley–and therefore we want them to rat out corporations.

I think that where it hurts the lawyers most is in the gray areas. Once you get to the point of real fraud and going to the SEC, I imagine most lawyers would have done something to disassociate themselves from the corporation.

MR. DAVIDOW: I would like to pick up on one point that John made and that relates to what you expect to happen with this noisy withdrawal rule. Ultimately a noisy withdrawal is unacceptable to all concerned. It's unacceptable to the client and it's unacceptable to the lawyer because it is setting off a bomb. What it ultimately does is give the lawyer additional clout where there is a disagreement between the client and lawyer. The client can no longer say, "I disagree with you. I'm the client. We do what I say." Instead it gives the lawyer leverage with which to say to the client, “Whether you like it or not, you have to do it.” That is a good thing if you think lawyers are going to be better at making those decisions than clients will, and it is a bad thing if you think clients will be better at making those decisions than lawyers will.

As John says, Sarbanes-Oxley seems to reflect a notion that overall we think lawyers will make the decisions better than the clients will, short of the situation where it comes to an impasse between the two. The question is: Will this lead
corporate officers and in-house counsel or others not to retain the outside counsel who might be strong enough to bring them to that point, but instead want outside counsel who are docile, who are under their thumb, who can be counted to go along and not get to that point? Maybe in some cases managers want passive lawyers, but I have to think that most general counsel and corporate officers will see it as in their interest to have more able lawyers and to have lawyers who do know how to say no when it needs to be said to protect them. It is in both the company’s and their individual interest in all but a very few cases for them to get the best and strongest advice that they can get.

PROFESSOR COFFEE: I want to make one comment between the two poles. You heard the position that the sky is going to fall in. And you have heard the position that this is a very effective technique for getting cooperation through negotiation. I would agree with the two scenarios that, to the extent things happen, they will happen behind the scenes through leverage and negotiation.

But I would just point out that since 1995 and the Private Securities Litigations Reform Act we have had a noisy withdrawal statute. It applies to auditors, and it goes beyond just withdrawing. It requires auditors to make noisy withdrawals and tell everything to the SEC. But nothing has happened; there have been maybe a handful of cases. Auditors find ways never to withdraw. Thus, my prediction is that auditors and attorneys are not much different. There are differences but they are not enormously different, particularly in the context of large corporations.

I don’t think we are going to see more than a handful of noisy withdrawals. It is not an argument against the rule, it’s not an argument for the rule. I guess I equivocally support the noisy withdrawal rule, but I don’t think it’s going to make a major difference and I don’t think we should expect that it will be one of the primary techniques for reducing white collar crime.

PROFESSOR REGAN: Let me follow up on something that John mentioned. This is the increasing sense that lawyers will be challenged from the perspective of 20/20 hindsight. One area in which this might occur involves the requirement under Sarbanes-Oxley that high ranking officials, such as the CEO and CFO, certify the accuracy of a company’s filings with the SEC. They must certify that the quarterly and annual reports fairly present, in all material respects, the company’s financial condition and results of operations and that the filings comply with the reporting requirements under the Act. There are criminal penalties for knowingly and for willingly filing false certifications.

As you may have seen, Richard Scrushy in HealthSouth, along with one of the series of CFOs that HealthSouth employed, have both been charged with violating this provision. My understanding is that there is no single template for corporations in determining how ultimately the CEO and CFO are going to have a good faith basis for making these certifications. One process that seems to be gaining favor, however, looks to a series of what are called “sub-certifications” lower down in the corporate hierarchy. This would involve people making representations about matters within the scope of their expertise and responsibility. Those sub-certifications then cumulatively will be the basis for the certifications at
the top. I’ve seen at least a couple of sample certifications that require lawyers to certify to the Chief Legal Officer, who then certifies to the CEO and CFO, that in essence, the filings are in conformity with the requirements of the act.

To what extent do you think that lawyers are going to be subject potentially to more exposure because of being put on the line to make those certifications? There is nothing in Sarbanes-Oxley itself that talks about liability for sub-certifying. But you can imagine a whole host of causes of action that might arise from assuming this responsibility. Anyone have a sense on how that is likely to play out?

MR. VILLA: I think it really depends on what the organized bar does to stand up to it. You get a sense of it with lawyers’ responses to audit letters that ask for information on possible litigation liability. There is a treaty that governs the responses of lawyers to audit letters, yet every day in every city in America there is an auditor who calls up a lawyer and asks—or demands much more than that. I think the bar, along with law firm insurers, are starting to focus on this, trying to figure out how they’re going to come out. And I have a prediction, which is that there will be no uniformity and it will depend a lot upon your relationship with the client. Those law firms that have long-standing relationships with clients where the relationship means a great deal to the law firm, stretches back over years, and involves enormous amounts of money and many matters, are going to have much less leverage and they’re going to sign these things. In other circumstances lawyers are going to simply say, “It’s a matter of policy. We’re not going to do it.”

With respect to liability, I haven't thought through all the implications. Certainly you are going to have potential false statements, you're going to have potential waiver issues. I think if you give a statement to your client that your client relies upon, and your client gets in trouble and then invokes your sub-certification, you are going to have an exception to the advice of counsel defense, and you may end up with a waiver of the attorney/client privilege. I must say I haven't seen a great deal of this so far and it's my hope it doesn't go beyond the anecdotal stage.

MR. SAUNDERS: I would say that I too have not seen very much. And my guess is that the bar will, if this becomes a major issue, push back and say, “We’re not going to do it,” similar to the audit letters, or there will be some kind of formulaic way of complying with the request.

On the subject of certification more generally, I think that the requirement for certification by the CEO and CFO is a good one because it heightens awareness inside the organization that there are, in fact, real consequences to filing false statements. Filing false statements has always been the basis for liability, so I don't think of the certification requirement as imposing an additional liability. It may make it easier for the SEC to prosecute you. But basically if you knowingly file a false 10-K, you are liable, whether you certified it personally or not. I also think that many corporations have done this sub-certification process, although it's different in different companies as to how far down in the organization it goes. I think the process is useful in making sure that throughout the organization, all the way down to a relatively low level, there is an awareness that people are going to be responsible and held accountable for the integrity of the financial reporting that the corporation as a whole is required to do. They can no longer say, “Well, that's the CFO's
problem, that's not my problem." Inside the organization they are now going to be on the hook.

PROFESSOR REGAN: I wonder however, at least with respect to CEO and CFO potential liability, whether these officers may feel less responsible because there is the opportunity now to claim faulty reliance on these sub-certifications as a source of any problems?

PROFESSOR COFFEE: I think that’s probably the wrong way to do it. There is an expansive side here to the extent that this is framed in terms of fair presentation. Without the certification you would be dealing with the narrow defense: do these financial statements comply with Generally Accepted Accounting Principles? Instead the CEO says that this statement that the company is filing, the 10-K or the 10-Q, fairly presents in all material respects the results of operations and financial conditions. That is a broader, more general statement. In fact, this essentially adopts Judge Friendly’s position in the Simon case. The standard is not “in compliance with GAAP”; the standard is “full and fair disclosure.”

I think this is a very intelligent strategy. Getting the CEO to sign ends what I will call the Jeff Skilling defense: “I’m not an accountant.” Once the CEO says the 10-K presents fairly everything about our financial condition and the result of operations it’s hard to say, “I’m not an accountant and I didn’t know.” You’re saying, “I’ve covered everything you should know.”

MR. SAUNDERS: Except that the Simon case is already the law, at least in the Second Circuit.

PROFESSOR COFFEE: It has been cited for the last 10 years.

MR. SAUNDERS: But it has been the law for 20 years.

PROFESSOR COFFEE: I agree.

MR. SAUNDERS: And it scares the daylights out of people who know about it.

PROFESSOR COFFEE: If there was any doubt it was the law, it now is the law.

MR. SAUNDERS: There is no question about that.

PROFESSOR REGAN: This also may provide a way for imposing liability on people at the top who set the tone for an organization but who otherwise might well not be knowledgeable enough to be subject to liability. There is an argument out there that Ken Lay was pretty much above the fray and wasn’t familiar with all the details of what Fastow was doing. At the same time there was also, I think, a fairly broad recognition that he created the sort of culture at Enron in which Fastow could flourish. Perhaps the certifications at least fill that gap in the existing state of the law.
MR. DAVIDOW: It seems to me the most useful way of looking at the certifications is not as a hook for getting the bad guys after the fact, but rather for the dynamic that we hope they’ll create within the company along the way. For the most part, I would say the certifications aren’t going to be effective in stopping the situations like they had in the financial department at WorldCom where the people in charge were the ones who were causing it to happen. But I hope that, as sub-certifications are required, the process will make people think and perhaps talk to other people within their department to elevate issues that the person higher up may not have known about or may not have focused on; and catch problems in the earlier stages before people feel the need later to cover them up or find ways to shield them from disclosure; and just as a matter of internal corporate dynamics, identify problems when they’re still manageable.

PROFESSOR REGAN: Let me turn to corporate compliance programs and in particular the Organizational Sentencing Guidelines, which since 1991 have provided a pretty strong incentive for companies to gain lenient treatment at least with respect to sentencing. To the extent they require companies to have in place what the guidelines call an effective legal compliance program, some administrative agencies, such as the EPA, have comparable programs. The advisory group to the Sentencing Guidelines Commission has recommended incorporating in the definition of an effective compliance program, one that fosters an organizational culture that promotes legal compliance. What are the panelists’ understandings of organizational culture? How important is it and what are ways in which it can be promoted?

MR. SAUNDERS: Before we address that, let me do this. In preparation for this panel discussion, because I knew you were going to ask this, I was curious to know exactly how many corporations were actually able to take advantage of the fact that they had effective compliance programs in sentencing. Now, my research is really anecdotal. I have the report from the Fiscal Year 2001. And in Fiscal Year 2001 there were 94 corporations sentenced under Chapter 8 of the sentencing guidelines, which is where the effective program is described. Of those 94, the corporations that were able to take advantage of leniency because they had an effective corporate compliance program was zero. There were two corporations that each had a compliance program that was deemed to be ineffective. And there were 90 corporations that had no compliance program.

PROFESSOR REGAN: In fact, the advisory group report that I mentioned indicates that from 1991 until early this year there were a grand total of three that had been able to take advantage of the guidelines.

MR. SAUNDERS: So the question is why are we talking about this if it never really matters in practice?

PROFESSOR COFFEE: There might be 5,000 corporations that have adopted a formal program to prevent and to detect violations of law.

MR. SAUNDERS: A formal program, but it is up to the U.S. Attorney to determine whether it is effective. And I can see some U.S. attorney saying, “Well, it obviously wasn’t effective because we convicted you.”
PROFESSOR COFFEE: I hear you. But I served on that 1991 committee that wrote the seven-factor test. And what the U.S. Attorneys on that committee all said is, “We don’t have the expertise to contest this. We just have to give them points for this because we are not going to be able to bring in corporation governance experts. We are just going to have to assume that their experts say this was a perfect system.” I don’t think you are going to see many U.S. attorneys thinking that they want to have a two-day hearing about the adequacy of this governance plan. It will be experts on one side versus one person standing up on the other side.

MR. SAUNDERS: The question is, is that really happening in practice?

PROFESSOR COFFEE: There is not much actual reliance on the guidelines, but we do have almost every company adopting a compliance program.

PROFESSOR KATYAL: Right. The numbers aren’t going to tell you that because the whole point is, ex ante, that people have adopted this. So the fact is that you may have avoided committing a crime by doing so.

PROFESSOR REGAN: There is a suggestion, at least in the report, that perhaps in charging decisions the existence and effectiveness of a program is taken into account. In fact, the size of the corporation that has been charged is fairly small. It’s not typically the large public corporation.

MR. SAUNDERS: Exactly right. There are very few corporations that have more than 5,000 employees that have actually, in fact, been convicted.

PROFESSOR REGAN: But talking about the broader question of organizational culture, whether it is codified in sentencing guidelines or elsewhere, people seem to acknowledge the significance of it, but it seems to be one of those things where you sort of know it when you see it. Is there any systematic way to try to foster a culture of compliance? The Guidelines Commission report mentions, for instance, adoption of a Code of Ethics. Well, Enron had a fairly substantial Code of Ethics. So that seems to be pretty much a pro forma gesture. Is there any way to get at that?

MR. SAUNDERS: Most large, at least most Fortune 500 companies, I think, have Code of Ethics or business conduct guidelines. The paradigmatic example was the IBM business conduct guidelines. They existed for 50 years and required every IBM employee above a certain level to certify once a year that he had received training on the guidelines and knew about them and so forth.

PROFESSOR REGAN: But does this provide any kind of assurance that the kind of culture that actually operates on a day-to-day basis is one that values legal compliance?

MR. VILLA: I don’t think so.

PROFESSOR COFFEE: No.

MR. SAUNDERS: I don’t know.
MR. VILLA: If you take a look at some of the companies that have gotten in trouble, many of them have a very positive corporate culture. And sometimes that corporate culture led to the problem in the sense that people who were such company men, so to speak, that they would do anything to advance the interest of the company, including meeting their competitors after dinner and talking about what they are going to do with prices. It isn’t just people who are out to benefit themselves and to line their own pockets. They’re people who are trying to advance their company’s interests and simply lose sight of where the lines are. So I must say I think that a Code of Ethics and company culture issues are not a good indication of how the corporation is ultimately going to perform. And when you have a large company and pick from a choice of 1,500 people, it becomes almost random. I mean, you have these people all over the country and many of them have decisions to make and problems are going to occur. You’re dealing with EPA regulations, Clean Air Act; it just depends on which one pops up.

I recall that I tried to get the benefits of the effective compliance program for one corporation and I did my research. At the time, I was submitting the sentencing memo and looked at it and thought to myself, “You know, if this becomes public everybody is going to say, ‘Why even have a compliance program?’”

This leads to another issue which was addressed in the report of the Ad Hoc Committee on Corporate Sentencing. They called it, I think, “the litigation trap.” Basically what they said is that the better your compliance program, the more problems you pick up and funnel to one place. As a result, the more you make yourself a target for civil litigants, the more you force yourself to go in and become a supplicant to either an agency or to a U.S. attorney’s office. And it is a real serious question as to whether or not that’s in the long-term strategic best interest of a corporation. I hate to say it quite cynically, but I agree with that. You don’t have any mechanism that protects that information and you have to think hard about whether it is in the best interest of your company to aggressively investigate.

PROFESSOR REGAN: I know Neal has actually given some thought to these kinds of trade-offs.

PROFESSOR KATYAL: I think that the advisory group identifies the problem correctly. It’s not that you want to promote good corporate culture; it’s that you want to promote a culture of compliance. I’m not sure that leniency under the guidelines will solve the problem.

Psychologists for 60 years have been studying how people behave in groups and one of the most interesting findings is the kind of strong conformity that group dynamics engender. So, for example, the classic experiment is to take three lines, a small line, a medium sized line, and a large line and put people in the group, and then give them a small piece of paper with a small line on it that matches one of the three lines on the board. And you say to them, “Which line on the board matches the one that you have on the small piece of paper in front of you?” There are a couple of confederates in the group who are with the experimenters who say, “Oh, well, this small line in front of me matches this big line on the board.” All of a sudden you get 1/3 of the people in the group saying that, “Oh, well, my small line matches the big line on the board.” These patently obvious false results happen over and over
again. Groups induce a certain amount of conformity and they also induce people to polarize towards extremes.

One approach that the advisory group is trying to take is to try and create some type of culture that attempts to get at that dynamic. I don’t think that compliance programs or Codes of Conduct themselves will do it. But one provision in Sarbanes-Oxley that is going to help, is one that will foster ombudsman programs, whistle blowers, and other things. It will help because all these studies about group dynamics that show massive conformity indicate that it can make a difference if just one person voices dissent saying, “That small line doesn’t match the big one,” explaining their reasoning. A solution that can change the culture of the group will, I think, be a better solution than adopting a Code of Conduct and ordering everyone to follow it.

MR. SAUNDERS: I want to make a further comment about Codes of Conduct, picking up on something that John said. I believe that it’s overly simplistic to think that a good Code of Conduct in a corporation is going to solve all the problems that we see today. What is happening inside large corporations today—especially when the market is not doing very well—is an intense focus on performance. That’s what matters inside a corporation: performance. You don’t get points inside a large corporation for being ethical and complying with the Code of Conduct. You get points for performance.

Among the most pernicious things I think in corporate America today are analysts’ expectations. Every single corporation, whether there is guidance from the corporation or not, is expected to perform in accordance with analysts’ expectations. Every quarter you pick up the newspaper and you grade every corporation, not by how ethical that corporation was in the last quarter or how many people complied with ethical guidelines or how many times the corporation blew the whistle on itself, but how did the corporation perform when compared to the analysts’ expectations. Pressures inside the corporation emphasize performance; in real life that’s what drives corporate behavior.

We won’t make progress unless and until we can get to a culture that says, “That kind of performance doesn’t really matter very much. What really matters is ethical behavior”—and we’re not there. Until we do get there, we are going to continue to see the problems of the kind that we have seen.

If the corporation is massively cooking its books or if it is massively capitalizing certain costs that should be expensed, it’s easy. But the problems that I see on a daily basis are not at the margins; they’re in the middle, where it’s really hard to see. For instance, “Should I recognize revenue now?” Most of the SEC enforcement actions today concern recognition of revenue. If someone could tell me what the rules are for recognition of revenue, maybe I could apply them. But the rules are not that clear. We’re talking about imposing liability for violating accounting rules that are not very clear, where there is tremendous pressure inside the corporation and from outside the corporation to perform by looking at earnings per share and revenue growth and earnings growth. And that, I think, is where the problem is. It’s not the way in which you comply with a Code of Ethics or Code of Conduct that people read once a year.
PROFESSOR REGAN: Let’s turn to one of our favorite subjects, which is lawyers. Jack, maybe you would like to describe very briefly a proposal you’ve floated in a recent draft paper about potential for lawyer certification of non-financial aspects of securities filings.

PROFESSOR COFFEE: To put this into context, I think you have to look at the late 1990s and conclude that there was a decline in the quality of disclosure; that too many companies were taking very aggressive, ambitious, sometimes reckless, and in a few cases fraudulent, postures towards their reporting obligation.

How should you deal with that? You can take what the SEC has proposed, a kind of noisy whistle-blower standard. That is a kind of obligation on the attorney to police the client. That is the hardest obligation to enforce. I think there is an intermediate position. I’m not necessarily against a noisy withdrawal, but I think that’s probably going to be a course that will be resisted by the bar and will produce only low visibility returns in a few cases. I think what you can do is tell the attorney and tell the corporation that there has to be a more formal process toward certain disclosure documents, such as the 10-K and the 10-Q. An attorney—preferably an outside attorney—has to, in effect, sign that document and provide a certification. It will not be the same as what the auditor provides because the attorney is not an auditor. Instead, the lawyer will certify that he believes that all statements made in the document are correct, has no knowledge that there are any false statements or material omissions, and understands that he would be subject to SEC sanctions for inadequate diligence. The standard of diligence would be what reasonable attorneys should do.

The bar will hate the standard, but I think it is a response to what I call “the fragmentation of the disclosure process.” The Powers Committee report on Enron points to the fact that most of the disclosures there were written by the chief financial officer. I don’t think the chief financial officer is ever going to have a real sense of what the securities laws demand or that people in his office are going to have the same sense as the attorney of what the securities laws demand with respect to what is a material fact regarding inherently legal questions. If we take seriously the idea that the profession should have a role in the disclosure process, I think the answer to some of the problems is to create a new gatekeeper.

The attorney today does not see himself as a gatekeeper in the disclosure process. The attorney sees himself as an advocate or transaction engineer, but doesn’t feel that she has responsibilities towards the disclosure document or towards public investors. I wish the attorneys did feel that they did, but I think legal ethics is couched in terms of the ethics of advocacy. And I think we have to move it marginally towards accepting a gatekeeper responsibility. The reason why I think this works better than dealing with some of the other reforms is that it says, “Here is a professional, a professional who has reputational capital and we want that professional to take some responsibility for doing a minimum level of due diligence with regard to the company’s most important disclosure statements, the 10-K and the 10-Q.”

Now, there are problems with this and I’m sure we will hear about some, but I think at least this would make a large difference, telling the attorney that he is a
critical gatekeeper. The statement can’t get filed without the attorney saying, “I have examined this and I have concluded after a reasonable investigation there is not a misstatement or material omission herein.”

PROFESSOR REGAN: Chuck and John and Paul, is Jack right, that the bar is going to hate this?

MR. DAVIDOW: Well, my reaction is that at least if asked to do that myself I would decline to do it. With inside counsel it may well be workable. And to the extent companies don’t already have their inside counsel involved, then getting them further involved would be an entirely positive development. Now, from the perspective of outside counsel, suppose a company comes to you, a company that is less than an enormous client of your firm. The company says, “We would like you to come and do some due diligence, spend $100,000 in fees, and sign the certification. Will you do that?”

MR. SAUNDERS: Not for $100,000.

MR. DAVIDOW: Not for $100,000, and probably not for a million dollars.

PROFESSOR COFFEE: It would change the process. You would have to do the entire preparation through the attorney. We would make the attorney the professional dealing with disclosure and he would no longer be an amateur.

MR. SAUNDERS: Jack, which attorney?

PROFESSOR COFFEE: I didn’t say that you couldn’t have the corporation’s chief legal officer doing it. But I think it would be a better solution if we have the outside law firm do what I think was done 20 years ago. In my time in the bar the outside law firm prepared the 10-K. You had a different system, where one law firm had a long-term relationship and prepared the 10-K on a regular basis. The outside law firm knew more about the company and did a much fuller disclosure. That’s history. As corporate general counsels came in and began to divide the business among multiple law firms, they tended to take this responsibility away from any single outside law firm, partly to increase the leverage that I think the general counsel wanted to have.

MR. SAUNDERS: You’re right.

PROFESSOR COFFEE: With a higher quality disclosure.

MR. SAUNDERS: Right. You may have had that, but those days are gone. General Motors probably has 500 law firms. Which law firm is it that is going to be doing the certification?

PROFESSOR COFFEE: You pointed out that no law firm would come in just to give the insurance certificate. I agree with that. I don’t want the law firm just to give the insurance certificate. I want to reestablish a system under which the law firm is the principal disclosure counsel to the company.
MR. SAUNDERS: No question.

MR. VILLA: The Antitrust Division is going to be after you soon.

PROFESSOR COFFEE: You also get higher quality disclosure.

MR. VILLA: Well, Jack and I have actually had this discussion. We talked about the fractionalization of corporate representation in recent years. Twenty years ago the great companies of America were represented by the great law firms of America, and they knew a great deal about most material matters. It’s just no longer true. I think corporate general counsels have prided themselves now on picking out the lawyer who is the best in each different area, whether it’s defense of their securities litigation, defense of their EPA matters, or of their antitrust matters.

I don’t understand how, as a practical matter for a company of over 1,000 employees, any law firm would give the certification. As a person who counsels law firms all the time, I would say it’s not covered by your liability policy. We would write an exclusion into the policy because it is just like walking in and saying, “I’m giving you an indemnity.”

I don’t believe that it’s the kind of area where corporations would say, “Okay, John, I’m going to hire you. How much do you really need? Seventy-five thousand? Are you really sure you need seventy-five thousand? Okay. Sixty? Forty? Thirty?” Because it’s not defending the lawsuit; it’s just giving them a certificate.

PROFESSOR COFFEE: That’s the whole point. The system has to be devised so that it is not simply an insurance certificate. You can start out with the general counsel having to sign a certification in order to file the 10-K. The general counsel might then want to get an outside law firm to do it. But any responsible outside law firm would only take the responsibility on if they were, in fact, doing the disclosure preparation. You wouldn’t give certification to a document done by the chief financial officer’s minions. That’s where the problem lies. When the 10-Ks and 10-Qs are written by the financial officer’s people, who have no idea what materiality really means, you are going to get a more cut and dried kind of compliance that cuts at the margins in response to the chief financial officer’s very different incentives. I think it would make a difference.

MR. SAUNDERS: It is a tremendous liability for the law firm, a huge liability.

PROFESSOR COFFEE: That is what fixing the disclosure system may take.

MR. SAUNDERS: Right.

PROFESSOR REGAN: Let me raise an issue that Paul raised with respect to incentives for corporate employees, and extend it to the context of incentives of lawyers in law firms. It builds on the observations about the attenuation of what formerly were long-term, relatively stable relationships between major corporations and their law firms. As we know, it’s an intensely competitive market and many law
firms have responded by changing compensation formulas to reflect business generation. There is much more lateral movement among law firms. There are firms that are willing, in essence, to lay off partners if they don’t meet certain revenue generation targets. It would seem that this creates enormous competitive pressures to be compliant with clients’ wishes, at least in many cases in which there is an argument that you could go either way, even though you may know better that you shouldn’t do it. What about those kinds of pressures? Aren’t they a significant factor in what has happened, what Jack calls the erosion of the gatekeeper model?

MR. VILLA: I actually don’t think so. One of the things I do is act as outside counsel to ALAS, which is the largest insurer of major law firms in the country, and I get to look at all the claims that come in. When you look at the claims you realize how few of them are people who seem to have turned a blind eye to something. It is often times people who just didn’t realize where they were going. I don’t think they were people who were motivated to try to maximize their law firm’s income. It comes up like that in only a relatively low percentage of cases. And I’m looking at maybe 600 cases. So I really don’t see fee maximization as being the principal driver of mistakes that law firms have made over the years.

When I take a look at what happens in major corporations where there is a problem, usually people are looking at incomplete information and they are trying to make a guess. And 80 percent or 90 percent of the time they’re right and there is really nothing wrong. And 10 percent of the time the additional information that comes in later shows that they were wrong and those are the people who get hammered, because a lot of people who have made decisions in these situations tend to be very good lawyers. They are just in a high-risk situation.

I don’t think the compensation systems at law firms have driven lawyers knowingly to engage in aiding and abetting misconduct. I do think that lawyers now are traveling around between firms and taking clients with them and they’re very protective of their clients, but I don’t think that has led people to securities fraud.

MR. SAUNDERS: I agree with John. I have not seen that in my practice. I really don’t think that’s the case. I think that more and more we are reverting to the days Jack was talking about, years ago when outside counsel acted as the general counsel, in effect, for large corporations. Now we are seeing corporations turning to their outside counsel more for advice on ethics issues. You don’t see corporations coming to outside counsel saying, “I want you to give me this kind of advice,” or “I want you to help me paper over this problem.” It’s really the opposite. It’s, “What should I do? What should we do?” And that’s the role that lawyers have traditionally played. Certainly when outside lawyers were acting as general counsel they were really the conscience of the CEO. We are starting to see more of that today, where the relationship is now between the CEO and the outside counsel, whereas, maybe 10 or 15 years ago it would be the general counsel to the outside counsel.

MR. DAVIDOW: To come at this another way, look at Arthur Andersen in the Enron situation. They had the partners who were responsible for that client relationship wanting to do certain things that Enron wanted them to do. When the issue was brought to the National Practice Group, the people there were opposed to
it, but the partners that handled the relationship were able to overrule them. This gets at an institutional problem that I think accounting firms and corporations certainly have and law firms may share. The issue is: how do you make sure that when problems arise or when hard questions arise, the person who is on the front line doesn’t play the Lone Ranger and do it by himself, but instead goes to someone whose primary interest is in the franchise of the institution rather than in getting in the next year’s payments. Not only do you need to find a way to make sure that it gets to people in that situation, but also that they’re the ones who have the final say and that the people of quality in the institution will want to have those positions.

A compensation structure can certainly discourage the kind of sharing that we’re talking about and can certainly discourage people from wanting to play the role in the institution that will put them in a position of making the ultimate judgments. It can therefore create situations where the institutional interest in getting it right isn’t given priority. Instead, the person on the front line who may have a countervailing interest is the one who makes the call. Law firm compensation systems can have that effect, although I don’t know specific instances where I can connect them to a poor judgment.

In terms of how I would set up a law firm and how I would go about making sure that the judgments are made correctly, I think the compensation system would be a part of it.

PROFESSOR COFFEE: Let me follow up. The in-house general counsel and the audit partner of a large client, a big five audit partner serving an Enron-size company, have one common characteristic, and it’s a characteristic that greatly complicates their position. They have a one-client practice. If you have a one-client practice you are dominated by the CEO. Instead, if you are one of the law firms represented here, you probably have a multi-client practice and you have better ability to resist. You can move your practice to some other client to some extent. So you are better able to negotiate, you have more leverage. That is why I have a little bit more confidence in advice coming from someone who doesn’t have a one-client practice.

That’s one part of the problem. The other part is the new practice of opinion shopping. Let me just briefly tell one story. This is probably the document that I think will be the most read over the next 10 years coming out of the current scandals. There is an independent examiner’s report on Spiegel, Inc. I don’t know if any of you have read it but it is a fascinating vignette. It essentially tells the story from the eyes of the independent examiner under which a very prominent law firm, Kirkland & Ellis in Chicago, is aware for 10 to 11 months that the company is failing to file its form 10-K and its 10-Q, which contain very material information. K & E quite properly advises the client that they must file their 10-K, that there are great liabilities if they do not file their 10-K. The company will not file because by filing any of these reports they would have to disclose that their auditor, KPMG, has put a going-concern qualification on its opinion—meaning that their auditor thinks they are going to go bankrupt. That assessment will greatly complicate their ability to work out certain pending negotiations with lenders. There is another law firm involved. It happens to be the German partner and office of White & Case, who knows no American securities law but is representing the principal shareholder in Spiegel, Inc. He gets to the audit committee and he tells the audit committee that all
these American lawyers are, in his vocabulary, “black painters.” “They do everything too pessimistically, they are painting the scene in black and they give too much weight to the SEC, which is a mindless, irrelevant body that you should ignore.” The audit committee listens to the German lawyer who does represent their controlling shareholder and ignores the American lawyer.

What happens thereafter for the 11 months that K & E keeps on advising them that they should file, K & E also keeps filing a document with the SEC called a Form 12B-25, under which you ask for a further extension. In the course of asking for these extensions and admitting that you have not filed, K & E keeps giving the justification that Spiegel has not filed because it’s in technical violation of certain loan covenants and it can’t file until it’s worked out these loan covenants. According at least to the independent examiner, that is not the real reason. The real reason is Spiegel wants to hide the fact that its auditor has given a going-concern qualification and thinks it’s already probably bankrupt. As to the law firm that has misstated in this way, the SEC will possibly see this as aiding and abetting the case.

I don’t want to focus on the aiding and abetting. I want to look at the model here. The independent examiner says, “They should have made a noisy withdrawal.” I would have to tell the independent examiner that there is no existing legal obligation requiring a noisy withdrawal at this stage. What should you do? Clearly, you cannot make a false statement that the reason for this delay is the technical loan covenants that we are amending, when down deep the reason is the company’s problem with its auditor regarding the corporation’s solvency. But here we have a situation where we have an excellent law firm giving good legal advice to the audit committee and nothing more is happening. Another lawyer is telling the committee to rely on his advice and they shop for opinions and they go the way they want.

This is a dysfunctional situation. The answer might be noisy withdrawal or the answer might be that we appoint a lawyer who can only make this filing if he says these statements are correct. And that kind of lawyer would not be permitted to file a statement, even if he is told by the client to file the 10-Q or the 10-K saying that, “We have delayed because we’re not in technical compliance.”

If you look at the Spiegel, Inc., story—which, I think is going to get a good deal of publicity in future months—I think you see that there are times when there could be a really dysfunctional situation where the board of directors is caught between rival opinions painting totally different pictures of the world. I think this is where you either have to have a noisy withdrawal rule, which is not my favorite rule, or some notion of gatekeeper responsibility under which you have to take some responsibility and you have to determine what the real reason is before you can file that form asking for an extension.

PROFESSOR REGAN: We have a few minutes left here in which we can throw it open to the audience to pose questions to any and all panel members.

PROFESSOR BAGGLE: You discussed the fact that part of what you saw as driving what happened in the late 1990s was this intense focus on corporate performance, on making your numbers. You suggested that the pressure was really not going to go away unless we found some way in which we can start to look at things such as whether a company is being ethical or not. I proposed in a law review
article about four years ago that the SEC expand its disclosure requirements to include numbers that might go to ethics. Things like employee safety, environmental compliance, things of that sort. Do you see any way that the modern corporation can, in fact, either acting with the government or alone, resist that performance pressure, and, if so, what would that be?

MR. SAUNDERS: I actually don’t. I’ve wondered for some time why corporations give guidance to analysts at all. Statements such as, “In the next quarter we expect to do 10 cents per share earnings and revenue will grow at 20 percent” or whatever. Every corporation does that.

I’ve said to many CEOs: “Why in the world do you give guidance? Why don’t you just do your job and the results are whatever they are without trying to predict what they’re going to be?” And every time I ask the question people say, “Well, the market needs it, the shareholders need it, people need that information.” Well, I don’t really think they do, but there is a tremendous built-in institutional pressure to do things like that. All you have to do to find out whether I’m right or not is look to see what happens to stock prices when corporations fail either to meet their own guidance or fail to meet analysts’ expectations. The stock will go down; it always does. They get penalized.

You can have as many brownie points as you want for having a good Code of Ethics or the fact that 90 percent of your employees went to ethics school last month or they went to church; that doesn’t matter. I think it’s Wall Street expectations of corporate performance that in real life do get translated into performance inside the corporation. Every time a corporation says, “Our guidance for the next quarter is five percent revenue growth,” I guarantee that within the corporation there is a ten percent target. It’s not five; it’s ten. And people get rated inside the corporation on their performance in proximity to that target. That’s business. That’s the way it works.

I don’t see any way, really, of changing it. We build in all these liabilities and we’re going to convict the corporation and we’re going to send people to jail for 20 years. I don’t think it is going to make any difference. First of all, a criminal conviction against a corporation accomplishes nothing in my view, except that it penalizes the current shareholders and may debar a corporation that does business with the government. But beyond that, nothing.

Take every one of the cases that we have been talking about and go back and ask, “How did this start at the beginning?” It started when there was a fear that the corporation wasn’t going to make its numbers for that quarter. I don’t know as much about WorldCom as Chuck does, but I guarantee that at the beginning, the concern was that WorldCom was not going to make its numbers for a particular quarter so they started looking inside the corporation for ways in which that could be accomplished. There are some ways to accomplish that lawfully and there are some ways that are illegal. Sometimes it’s hard to tell the difference.

PROFESSOR COFFEE: Can I add one sentence to this because you are not describing the world as it always was. You’re describing the late 1990s. And the reason why you are in the 1990s is that something invisible happened. We’re all focused on lawyers today, but lawyers are the agents. The behavior of the principal
remained unchanged until about 1992, when the compensation of the chief executive officer was 92 percent cash, 8 percent equity. Today as of 2001, it’s 67 percent equity, 33 percent cash. Stock options became the principal mode of compensating senior management. That’s when you get the pressure to make the numbers.

They didn’t care that much about quarterly day-to-day stock performance when they were compensated in cash. They care greatly when they have stock options and they have the ability to bail out if the market is going to turn around. We’re not going to get around stock options; don’t misunderstand me.

MR. SAUNDERS: Right.

PROFESSOR COFFEE: But I think there are a number of things that can be done, including expensing stock options, including retention ratios, including shareholder activists in dealing with a mandatory ratio: how much you have to hold, minimum holding periods that would reduce at the margin, only at the margin—when there’s the pressure to make the numbers. Now we’re talking about what motivates the principal, and so far today, we have been talking about how we affect the behavior of the agent.

MR. SAUNDERS: I agree with that in part. There’s no question that stock options in the 1990s period were important, but that’s not the whole story. All you have to do is look at the number of CEOs that got fired for not meeting their targets. It’s not just how much money I’m going to make if I do, but it’s what happens to me if I don’t, and it’s both.

PROFESSOR REGAN: Let me thank everyone for just a wonderful, fascinating discussion. We are really very fortunate to have such a first-rate group of people.

PROFESSOR BLAIR: I found it amazing that as we have gone through seven panels that we kept circling back around and finding ourselves talking about the same things. They all seem to be connected to the point which came up at the very end—the urgency of meeting the numbers and the way in which executives are compensated.

I think it has been a terrific two days. I want to thank everybody who has been a part of it. It will take me a while to absorb it all. Thank you very much.