1999

Institutions of a Capital Market Economy: Independence in Modern Corporate Governance

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William T. Allen, University of Delaware, April 1999

University of Delaware

College of Business

Business Policy Series

Wilmington, Delaware

April 15, 1999

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This morning I want to talk about our system of corporate governance and specifically about the role and value of independence in corporate governance. If that topic seems a bit abstract, let me suggest that it is of real practical importance and value. That value derives from the assurance that capital markets can take from the fact that those playing important corporate governance roles are exercising some level of informed independent monitoring of management's plans, strategies and performance. That assurance can be valuable. It can lower the costs of capital to the firm and to the economy as a whole. And its absence can be costly in the same way. Without independent directors and independent auditors and other professionals, our system-wide costs of capital will be higher than they need to be. Thus is one important part of a transparent, responsive and effective corporate governance system that can over time add real value to national economies.

But I should note at the outset that, while I am a strong advocate of an element of independence in governance, it is important to keep in mind that independence on the board or of corporate advisors is an instrumental, not the ultimate, goal of corporate governance and it comes at some cost. We seek independence not as a holy grail, but because we believe it will help us get something else and that other more ultimate thing we seek is greater efficiency and increased human welfare that greater efficiency can bring.

I.

Specifically I would like to talk about why we value independence in corporate governance, what we mean by independence and what threats to independence we need to protect against. The focus of my remarks is upon the governance of the large publicly financed business corporation. These corporations occupy the center stage in our productive economy.

It would be difficult, in fact, to overstate the importance of these institutions. All of the great scientific and technological innovations that have revolutionized our daily lives -- electricity and electrical appliances, the internal combustion engine, telephone, radio and television, aeronautics, plastics, pharmacology and cybernetics to mention just the most obvious life-enhancing technologies -- have affected us chiefly through the medium of *commercial exploitation within the corporate form*. Moreover, the corporations that have accomplished this work have not simply exploited new knowledge uncovered by others but have served as an important source of research and innovation themselves. Systematic efforts at the Bell Labs, the DuPont Experimental Station, at General Electric, Pfizer, Genetech, Intel and many others have undoubtedly served as an important source of basic scientific discoveries and applied product development. In the process these firms improve the lives of customers while enhancing financial returns of investors.

There is no mystery why the advances of modern science have tended to be commercially exploited by large publicly financed corporations, rather than through some other form of organization. The corporate form – especially the publicly financed corporate form – offers important efficiency advantages over alternatives ways to organize large scale economic undertakings. Most simply, it offers a technique to spread investment risk and assure investment liquidity while at the same time assuring stability, availability of capital, and the expertise and speed of central managers. These advantages reduce the risks and thus the cost of investing. They are powerful. Indeed they are so powerful that, unless changes in technology reduce the fundamental sources of economies of scale and scope that have existed since the early industrial revolution, there is every reason to suppose that the corporate form will continue to dominate our economy throughout the 21st Century. How these institutions are funded, managed and governed will continue to be a question of public concern and importance.

How any legal system provides for the necessary capitalization of large scale enterprises and how it controls, regulates, and provides for their governance are of course among the most fundamental issues of political economy and their resolution is subject to continuing evolution in our daily commercial and political lives. An observer of the evolution of our own system of legal regulation of economic activity over the last thirty years could not fail to notice a gradual but cumulatively striking change in the extent to which we are turning away from administrative law as we attempt to channel economic choice and turning towards markets. We of course have always organized ourselves largely around free exchanges on markets, but in the twentieth century governmental regulations of economic choice grew enormously as we tried to deal with the social consequences of the Second Industrial Revolution. But from a high-water mark of governmental control of the market in the late 1960s, the tide has been running in the other direction. One cannot help but observe that over the last thirty years in one field after another we have turned from administrative law towards markets as a means of organizing and directing economic activity. Look at interstate trucking or air travel; consider the production and distribution of natural gas or more recently of electrical utilities. Think about telecommunications or the huge fields of banking and finance. In each of these fields and others it is clear that we depend on competitive markets more thoroughly than ever before in this century. I personally regard this shift as growth in understanding and altogether healthy.

The deeper causes of this evolution I leave for another occasion. But I mention it now because one might suppose that the enhanced disciplinary effects of the more competitive product and capital markets today would make internal corporate governance less important now than earlier. While, it is probably the case that more competitive global markets *have* improved the internal efficiency of surviving firms, nevertheless any view that governance rules and practices are less important than they were would in my view certainly be incorrect.

First from the perspective of the performance of the individual firm, as global markets grow more powerful and margins grow tighter, competitive advantage must be sought in every attribute of the firm -- including its governance. Despite the unclarity of empirical studies on the effect of certain governance practices on efficiency or stock price, most of us believe that effective governance will impact the long-term productivity of the firm.

Second, from a system-wide perspective, more powerful markets depend upon the disclosure of relevant and dependable information to those markets. And they depend upon institutional safeguards of the reliability of that information and the integrity of those exercising corporate power. Capital market participants in particular depend upon effective corporate governance safeguards to assure that management truthfully discloses relevant information and acts fairly respecting investors. Thus, in my view, it is even more true in the world of more competitive markets than it was earlier time that suppliers of global capital perceive that the U. S. corporate governance system is a process with integrity

II.

Not just investors but all interests in the economy -- investors, workers and politicians -- must be able to trust the fundamental integrity of those who do exercise discretionary judgment over the huge aggregations of property that they control. But investors are the first concern of corporation law and policy. Our system of publicly financing the riskiest portion of the large firm's balance sheet with widely distributed and traded equity exposes us to particular risks. This system can only work if investors believe, within some acceptable range, that our great public corporations are operated by men and woman of integrity *and* within systems that are designed to deter the temptations to self enrichment to which we frail humans are ever susceptible.

Thus to state the obvious: It is impossible for a complex modern economic system, which inevitably is built upon agency relationships, to function with acceptable level of efficiency if the agents acting within it are corrupt. Corruption of course exists in various forms and to varying degrees. But it is essential for the efficient functioning of our economy that we maintain an acceptable level of confidence in the integrity as well as the skill and diligence of the successful individuals who are in control of our great publicly financed corporations. *Independence from corporate management of some of those filling key governance roles is an important part of the way our system seeks to maintain trust in the integrity of the existing system.*

This trust that our polity and particularly its savers and investors has conferred on our private enterprise system is economically of inestimable value. We protect and sustain the plausibility of that trust both culturally and institutionally. Thus our legal system contains elaborate safeguards designed to help our capital markets centered system work.

> *First* through the Securities and Exchange Commission we mandate <u>extensive financial disclosure</u> in connection with the initial solicitation of share investments.
>
> *Second,* we mandate periodical submission to a public file of financial and operating data. That disclosure will include financial statements prepared in accordance with <u>mandated generally accepted accounting standards and will be attested by an independent professional auditor</u>.
>
> *Third*, we protect stock market integrity <u>by prohibiting fraudulent or manipulative practices</u> in connection with the purchase or sale of stock of public companies, including the prohibition of trading on inside information.
>
> *Fourth*, because do not want to straight-jacket management with a lot of narrow rules, but we do seek protection against corruption of agents, we supply the judicial protection of <u>fiduciary duty</u> review. Judicial review under the fiduciary duty standard allows a court to evaluate the fairness of any transaction in which a corporate officer or director has a personal financial interest adverse to that of the corporation.
>
> *Fifth,* we <u>protect the integrity of stockholder voting</u> both by mandated disclosure and by the post hoc judicial protection of fiduciary duty.
>
> *Lastly,* we place final legal power over the corporation in a body – the board of directors – <u>elected directly by the stockholders and we impress upon the board a duty of loyalty to the corporation and the stockholders.</u>

Thus the U.S. corporate governance system facilitates investment in corporations by mandating minimum required disclosure according to generally recognized standards; by assuring shareholder voice through the shareholder election of the board; and by enforcing upon corporate directors and management a broad fiduciary duty of loyalty to the corporation.

But compliance by the board and management with their respective obligations under all of these protective arrangements still *leaves enormous room for the exercise of discretion*. For example, generally accepted accounting practices leave broad discretion in the hands of those who create or attest to financial statements. Financial statements are the result of countless judgments about appropriate accounting treatment concerning such things as the recognition of income, the creation of reserve accounts, or the right of R&D costs in a merger. Similarly, the creation of appropriate plans for management compensation or firm investment are inevitably questions of business judgment <u>that are practically speaking all but unconstrained by existing legal regulation</u>

It could not sensibly be otherwise. Attempts to eliminate discretion would ham-string corporate management and costs us dearly in terms of the overall productivity. So then, how can we offer reasonable assurance to investors that that necessary discretion will be exercised in a good faith attempt to achieve the corporate good? That those possessing this discretion will act with integrity? This is the central problem of corporate governance in our system.

Thus we are driven to the conclusion that it is essential for this sort of system for those who occupy corporate governance roles to act not only with energy and intelligence, but very fundamentally***, to act with integrity. –*** that is to act in accordance with judgments honestly made in conformity with their announced and approved standards.

But integrity is hard to evaluate *ex ante*. We can't see it or weigh or touch it. We can of course make estimates about it in any particular case but we would need to know quite a lot of information to sensibly do so. *So, seeking integrity and objectivity we have to settle for independence as a proxy for integrity and objectivity*. We do this on the simple assumption that one without a conflicting or shared interest it is less likely than one with such an interest to be tempted to make a decision on a non-merits basis.

Ultimately, the independence that we seek is independence in the exercise of judgment – but that characteristic is unknowable in precisely the way that integrity is unknowable. Therefore the law tends to focus upon a more easily knowable "objective" view of independence. That view looks at the relevant circumstances of the decision-maker and especially at any relationship or interest that he or she may have with respect to the decision. It then asks whether the judgment of a normal or average person – a hypothetical reasonable man—would in these circumstances risk being affected by such interest or relationship.

The importance of independence in corporate governance is not difficult to see and the advantages of taking a primarily "objective" approach to standards of independence – even though what we really want is a subjective quality of mind-- seems easy to grasp. What then are problems with assuring that we have an appropriate degree of independence in our system? That directors exercise appropriately independent judgment; that auditors pass a fully disinterested and independent eye over the books of their audit clients and that compensation consultants or other advisors consider only the corporations interest and not their own interest in future employment in giving advice?

III.

The overarching concern respecting independence of directors, advisors or auditors is that in exercising their respective judgments they maintain loyalty to the corporation or its investors rather to management who hires them. But independent directors or auditors or other experts cannot be adversaries. Since management acts as the main informed agency responsible for advancing the corporations mission under the general direction of the board, it needs and generally deserves a certain amount of trust and deference in the exercise of decisions. Thus differences between management and individual board members or between management and the auditor are inherently rare and difficult. Logically, they may be rare because deference to management is justified and rarely abused or, alternatively, because directors and auditors as well as advisors have substantial economic and psychological pressures to defer to management in the exercise of its discretion in gray areas.

The occurrence of the occasional governance failure – Cendant, Livent, or a few years ago G.M., IBM or American Express—gives support to those who fear the second interpretation is the more likely.

Those with responsibility for the operation of the corporate governance system – here I refer principally but not exclusively to the Securities and Exchange Commission -- are obliged to try to find ways to encourage the exercise of independent, informed judgment by directors and auditors. The SEC is of course very alert to the possible effects of governance failures. It currently is powerfully focused upon what it sees as serious risks to the integrity of financial statements. Chairman Levitt was eloquent on that subject in his widely noted speech last fall at the NYU Center for Law & Business. The Office of Chief Accountant and the Enforcement Division have both been highly energetic in demonstrating that the SEC intends to scrutinize accounting treatments in mergers and in other settings and they will actively investigate and prosecute accounting irregularities. Reasonable fear of a loss of auditor independence is a primary driver of this SEC concern.

As the Big Eight of Accounting rapidly evolve into the Big Five of Global business advisory services, there is distrust on the part of the SEC and perhaps in the capital market, that the ability of these firms to make hard judgments that displease their audit clients may be eroding. The fear is that as the multi-service firms increasingly look to higher margin non-audit work for a larger portion of their revenue stream they will have increasing incentive to use auditing as a marketing arm, with a sharply increased disincentive to resist an aggressive clients demands.

While this evolution may be seen as problematic from the perspective of one solely concerned with perceptions of independence, there are almost certainly some efficiencies in permitting such multiple services. In 1997 the SEC delegated to the newly formed Independence Standards Board the task of creating principle-based standards for the determination of auditor independence. The Independence Standards Board has been proceeding in a deliberate way to grapple with the relevant issues. Our goal is to fully assure corporate investors that auditors who are free from any relationship or interest that, in the circumstances, might affect the judgement of a reasonable person, have attested to published financial statements. At the same time we seek to create standards compatible with the efficient delivery of auditing services to preparers and to users of financial statements. Our first official standard mandated that auditors discuss the facts bearing on their independence with the audit committee of their audit client.

The recently issued Report and Recommendation of the Blue Ribbon Committee on Corporate Audit Committees can be seen as a related attempt to enlist the corporate board in an effort to assure that auditors are independent and act in the best traditions of the auditing profession when interacting with management. The recommendations of that report are not radical and in most respects are not new. The Treadway Commission's excellent report made many of the same points. The activities the Report recommends are largely a part of the existing uncodified responsibility of independent directors who serve on the audit committee, and while respected authorities tend to see real risks to enhanced liability potential in the recommendations things, I do not. The Report is an attempt to stimulate one part of the governance mechanism to interact appropriately with another. In considering whether it represents good policy or not, we ought not, I think, to allow our control over this important public policy matter to be held captive to the ability of class action lawyers to file merit-less lawsuits.

Let me close. For a long time in this country it was deemed to be the sophisticated view that independent directors could add little or nothing to corporate governance and the long-term performance of large corporations. This view was highly conventional, but it represented the triumph of comfort over ambition. It was true so long as everyone acted as if it were. But things have changed. Boards today are smaller, meet more often, are populated almost entirely with outside directors, and are more focused on stock price than formerly, for good or ill. The reality of board service has changed. Independent directors are accepting a heightened responsibility. This is generally for the good I suppose.

At the moment the U.S. corporate governance system tends to be the hero in the academic finance world, not surprisingly. Certainly much has been done to effect desirable and moderate change. All of those directors' investors and others who played a role, can be proud. But we still need to broaden our concerns beyond boards to other critical governance actors: auditors, lawyers and compensation consultants particularly. Auditors are actively under consideration by the ISB. The independence of the legal profession is a part of its traditional identity, but one that is entirely submerged by the dominant and beneficial role of zealous advocate.

The next great need is the innovation of a credible system of un-biased investor responsible compensation consultants. But I will leave that subject for another day.