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Chapter 4

Recent U.S. Governance Reforms

4.1 Recent Governance Reforms: An Executive Summary

In the aftermath of the governance scandals around the turn of the century, the government, regulatory authorities, stock exchanges, investors, ordinary citizens, and the press all began to scrutinize the behavior of corporate boards much more carefully than they had at anytime before. The result was an avalanche of structural and procedural reforms aimed at making boards more responsive, more proactive, and more accountable, and at restoring public confidence in U.S. business institutions. For a more detailed summary of these and related governance reforms, see, for example, Morgan Lewis, Counselors at Law, “Corporate Governance: An Overview of Recently Adopted Reforms” (2004); or Petra, “Corporate Governance Reforms: Fact or Fiction, Corporate Governance” (2006), pp. 107–115.

The congress passed the Sarbanes-Oxley Act of 2002, which imposes significant new disclosure and corporate governance requirements for public companies and also provides for substantially increased liability under the federal securities laws for public companies and their executives and directors. Subsequently, the NYSE, NASDAQ, and AMEX adopted more comprehensive reporting requirements for listed companies, and the Securities and Exchange Commission (SEC) issued a host of new regulations aimed at strengthening transparency and accountability through more timely and accurate disclosure of information about corporate performance.

The most important changes concern director independence and the composition and responsibilities of the audit, nominating, and compensation committees. Additional reforms address shareholder approval of equity compensation plans, codes of ethics and conduct, the certification of financial statements by executives, payments to directors and officers of the corporation, the creation of an independent accounting oversight board, and the disclosure of internal controls. They are described in some detail in [Chapter 12 "Appendix A: Sarbanes-Oxley and Other Recent Reforms"](#) of this book.

It is important to understand the rationale behind some of the most far-reaching reforms. The rationale for increasing *director independence* was that shareholders, by virtue of their inability to directly monitor management behavior, rely on the board of directors to perform critical monitoring activities and that the board’s monitoring potential is reduced or perhaps eliminated when management itself effectively controls the actions of the board. Additionally, outside directors may lack independence through various affiliations with the company and may be inclined to support management’s decisions in hopes of retaining their relationship with the firm. Requiring a board to have a majority of independent directors,

therefore, increases the quality of board oversight and lessens the possibility of damaging conflicts of interest.

Audit committee reforms are among the most important changes mandated by Sarbanes-Oxley. The reasons behind these reforms are self-evident. Audit committees are in the best position within the company to identify and act in instances where top management may seek to misrepresent reported financial results. An audit committee composed entirely of outside independent directors can provide independent recommendations to the company's board of directors. The responsibilities of the audit committee include review of the internal audit department, review of the annual audit plan, review of the annual reports and the results of the audit, selection and appointment of external auditors, and review of the internal accounting controls and safeguard of corporate assets.

Compensation committee reforms respond to the unprecedented growth in compensation for top executives and a dramatic increase in the ratio between the compensation of executives and their employees over the last 2 decades. A reasonable and fair compensation system for executives and employees is fundamental to the creation of long-term corporate value. The responsibility of the compensation committee is to evaluate and recommend the compensation of the firm's top executive officers, including the CEO. To fulfill this responsibility objectively, it is necessary that the compensation committee be composed entirely of outside independent directors.

Nominating new board members is one of the board's most important functions. It is the responsibility of the *nominating committee* to nominate individuals to serve on the company's board of directors. Placing this responsibility in the hands of an independent nominating committee increases the likelihood that chosen individuals will be more willing to act as advocates for the shareholders and other stakeholders and be less beholden to management.

4.2 Analysis: Stronger Governance or Regulatory Overkill?

To assess the efficacy of the new regulations, it is useful to ask whether Sarbanes-Oxley, the new accounting rules, or any of the other reforms would have prevented some or all of the (U.S.) 2001 scandals. In an insightful paper, Edwards asks four key questions: Edwards (2003).

1. What motivated executives to engage in fraud and earnings mismanagement? Or, put differently, is there a fundamental misalignment between management's and shareholder interests and, if so, what are the causes of this misalignment? The term "earnings mismanagement" is used in the widest sense to include not only reporting that is illegal or inconsistent with accepted accounting standards but also statements that, while within accepted legal accounting standards, are primarily meant to deceive investors about the company's true financial condition
2. Why did boards either condone or fail to recognize and stop managerial misconduct and allow managers to deceive shareholders and investors? Are the incentives of board members properly aligned with those of shareholders?
3. Why did external gatekeepers (e.g., auditors, credit rating agencies, and securities analysts) fail to uncover the financial fraud and earnings manipulation, and alert investors to potential discrepancies and problems? What are the incentives of gatekeepers, and are these consistent with those of shareholders and investors?
4. Why were shareholders themselves not more vigilant in protecting their interests, especially large institutional investors? What does this say about the motivations and incentives of money managers?

The Link Between Compensation Structure and Earnings (Mis)Management

As Edwards notes, it is now widely recognized that the dramatic changes in the compensation structure of American executives adopted in the 1990s were a significant contributing factor to the higher incidence of "earnings (mis)management." Consider that, in 1989, only less than 5% of the median CEO pay of the Standard & Poor's 500 industrial companies was equity-based—95% or more consisted of salary and cash bonuses—but by 2001, equity-based components had grown to two thirds of the median CEO compensation. Hall and Murphy (2002), p. 42. Since stock options accounted for most of this increase, executive pay became far more sensitive to short-term corporate swings in performance. It is now also

recognized that a change in tax law—the addition of section 162(m) to the IRS code—was a major contributor to the increased use of stock options. For more on this subject, see [Chapter 8 "CEO Performance Evaluation and Executive Compensation"](#) in this volume. As long as stock prices climbed, executives could exercise these options profitably. The incentive to report (or misreport) continued favorable company performance was therefore substantial. Enron's executive compensation was closely linked to shareholder value. Enron senior managers, therefore, had a strong incentive to increase earnings and the company's (short-term) stock price. Edwards (2003).

This analysis suggests that we must reevaluate how equity-based compensation is used to motivate executives and, in particular, whether there are pay structures that mitigate or eliminate incentives to misreport. The basic rationale behind equity-based compensation is sound: to motivate managers and better align manager and stockholder interests. But such pay structures must promote long-term value creation rather than reward short-term fluctuations in share prices.

Were Boards Asleep at the Switch?

Why were boards not more alert to managerial misbehavior? To answer this question, Edwards once again turns to the Enron scandal. Edwards (2003). The company met or exceeded most governance standards. Its 14-member board had only 2 internal executives: its chairman and former CEO Kenneth Lay and President and CEO Jeffrey Skilling. The remainder of the board consisted of 5 CEOs, 4 academics, a professional investor, the former president of one of Enron's wholly owned subsidiaries, and a former U.K. politician. So, on paper, at least, the vast majority of Enron's directors met the "independence" requirement. See Enron's proxy statement, May 1, 2001. Subsequent to Enron's collapse, the independence of some Enron directors was questioned by the press and in Senate hearings because some directors received consulting fees in addition to board fees. Enron had made donations to groups with which some directors were affiliated and had also done transactions with entities in which some directors played a major role. Moreover, all had a significant ownership stake in Enron, so their interests should have been aligned with those of Enron's shareholders. The beneficial ownership of the outside directors reported in the 2001 proxy ranged from \$266,000 to \$706 million. See Gillan and Martin (2002), p. 23.

Enron's board structure was also strong; the audit (and compliance), compensation (and management development), and nominating (and corporate governance) committees all were made up outside independent directors. In fact, the audit committee's state-of-the-art charter made it the "overseer of Enron's financial reporting process and internal controls," with "direct access to financial, legal, and other staff and consultants of the company," and the power to retain other

(outside) accountants, lawyers, or whichever consultants it deemed appropriate. See Gordon (2003).

Yet, what actually happened at Enron is very different. The Congressional Subcommittee on “The Role of the Board of Directors in Enron’s Collapse” concluded that the board failed in its fiduciary duties (its duties of care, loyalty, and candor) because it permitted high-risk accounting, inappropriate conflict of interest transactions, extensive undisclosed off-the-books activities, inappropriate public disclosure, and excessive compensation. This subcommittee is administered by the Permanent Subcommittee on Investigations, Committee on Governmental Affairs, United States Senate, July 8, 2002.

Whether or not this is a fair assessment of Enron’s board performance, it shows that in an environment of short-term, equity-based incentives combined with less than transparent financial disclosure, the potential for manipulating financial results is real and that boards must be especially diligent. Many believe the Enron board did not meet this higher standard of care.

Would Sarbanes-Oxley and the new NYSE governance rules have prevented the Enron debacle? It is hard to say. The company already met some of the new requirements, such as independence for board members and key committees. Others, for example, the new rules requiring the elimination of conflicts of interest among board members and greater disclosure of off-balance sheet arrangements and other transactions to investors, might have made a difference. In the end, however, it is highly questionable whether ethical behavior can be legislated into being. Changing the ethics of business behavior and the “sociology” of the boardroom cannot be accomplished through structural changes alone; they require fundamental cultural change, which is a far greater challenge. In his 2003 letter to shareholders, Warren Buffett summed it up well when he confessed he had often been silent on management proposals contrary to shareholders interests while serving on 19 boards since the 1960s. Most boards, he said, had an atmosphere where “collegiality trumped independence.” Warren Buffett’s letter to Berkshire Hathaway shareholders, as quoted in *USA Today*, March 31, 2003.

Did the Gatekeepers Fail?

What role could gatekeepers—external auditors, investment bankers, analysts, and credit rating agencies—have played in staving off the Enron and other scandals?

As noted in [Chapter 1 "Corporate Governance: Linking Corporations and Society"](#), one view holds that gatekeepers are motivated and well positioned to monitor corporate behavior because their business success ultimately depends on their

credibility and reputation with investors and creditors. Lacking this credibility, why would firms even employ gatekeepers? While this may be true, we should also inquire whether the interests of gatekeepers may be more closely aligned with those of corporate managers than with investors and shareholders. Gatekeepers, after all, are typically hired, paid, and fired by the very firms that they evaluate or rate, and not by creditors or investors. Edwards (2003). This holds for auditors, credit rating agencies, lawyers, and, as we learned in a number of high-profile law suits, **security analysts**¹ as well those whose compensation (until recently) was directly tied to the amount of related investments banking business their employers (the investment banks) did with the firms that they evaluated. As noted by Edwards (2003), Citigroup paid \$400 million to settle government charges that it issued fraudulent research reports; and Merrill Lynch agreed to pay \$200 million for issuing fraudulent research in a settlement with securities regulators and also agreed that, in the future, its securities analysts would no longer be paid on the basis of the firm's related investment-banking work. Also see Coffee (2002, 2003a, 2003b); Stewart and Countryman (2002). Thus, an alternative view is that most gatekeepers are inherently conflicted and cannot be expected to act in the interests of investors and shareholders. And while recent reforms separating consulting from auditing services, restoring the "Chinese Wall" between analysts and investment banks, and mandating term limits for auditors help mitigate these problems, it is unlikely that they would have prevented or minimized scandals, such as Enron and WorldCom.

Could Institutional Shareholders Have Made a Difference?

It is a basic tenet of free-market capitalism that the system rests on the effective ownership of private property—that is, that owners choose how their assets are used to their best advantage. The popular question, "Do you know anyone who washes a rental car?" is appropriate here. Yet, the largest single category of personal property—stocks and shares (including the beneficial interest in stocks and shares held collectively via investment institutions, mainly to provide retirement income)—lack effective ownership. Those who hold shares directly—in the United States, 50% of all shares are held directly—are individually so small as to be virtually powerless. Only if shareholders can unite effectively—and, in practice, this applies only to institutional shareholders—will corporate managements be held accountable. This seldom happens except in a rare corporate crisis, by which time the damage often has been done.

In the United States, more than half of all shares are owned by life insurance companies, mutual funds, and pension funds. So-called 401(k) plans, retirement savings plans funded by employee contributions and matching contributions from the employer, have become a major factor. Mutual funds compete heavily for this business. In theory, therefore, their corporate governance activities, if any, can

1. Individuals whose expertise is in evaluating stocks and bonds.

make a crucial difference. With the exception of few public pension funds, however, institutional investors have not played an active role in monitoring corporations. Instead, they have been content to do nothing or simply sell the stock of companies where they disagree with management's strategy. One could argue this behavior is rational. Any other course of action is likely more costly and less rewarding for their shareholders and beneficiaries. Moreover, institutional fund managers themselves have serious conflicts of interests that incentivize them against direct intervention to prevent corporate misconduct. Their compensation—typically a flat percentage of assets under management—depends largely on the amount of assets under management. Retirement funds originating with corporations have been the most important source of new funds. Mutual fund managers, therefore, are unlikely to engage in corporate governance actions that antagonize corporate managers for fear of losing these pension funds. The law also discourages institutional investors from acquiring large positions in companies and taking a direct interest in corporate affairs, which would give institutional investors a greater incentive to engage in active corporate governance. For example, the “five and ten” rule in the Investment Company Act of 1940 is a clear attempt to limit mutual fund ownership, and section 16(b) of the Securities and Exchange Act of 1934 (the “short-swing profits” rule) discourages mutual funds from taking large equity positions and from placing a director on a portfolio company's board of directors. The Securities and Exchange Act of 1934 requires that at least 50% of the value of a fund's total assets satisfy two criteria: an equity position cannot exceed 5% of the value of a fund's assets, and the fund cannot hold more than 10% of the outstanding securities of any company.

Thus, making institutional investors more active and more effective corporate monitors—while attractive from a theoretical perspective and consistent with the basic tenets of American capitalism—involves complex legal, structural, and philosophic issues: Should we encourage larger ownership in firms and more activism by institutional investors? What are the motives and incentives of fund managers, and are they likely to be consistent with those of shareholders? If we do want to encourage more institutional activism, do we want to encourage active ownership by all institutions and, in particular, by public pension funds, which may be conflicted by public or political interests? Finally, what structural and legal changes must be made to change the culture of institutional passiveness and bring about more activism? These questions are adapted from Edwards (2003). We also note that the Securities and Exchange Commission (SEC) recently made progress on this issue by requiring that a majority of mutual fund boards be comprised of “independent” directors, and by changing the definition of “independence” to be the same as that employed by Sarbanes-Oxley and the New York Stock Exchange.

4.3 Synthesis: What Is the State of U.S. Corporate Governance?

Has investor confidence been restored? Were the various regulatory changes effective? How sound is the American corporate governance today? As we begin to answer these questions, it is important to note that the U.S. corporate governance system has been roundly criticized and the subject of vigorous debate for many years. In 1932 Berle and Means warned that changes in ownership patterns would foreshadow “governance co-opted by management”; Mace has likened boards to “ornaments on a Christmas tree”; Drucker said boards “do not function”; while Gillies proclaimed that “boards have been largely irrelevant throughout most of the twentieth century.” Berle and Means (1932), p. 62; Mace (1971), p. 3; Drucker (1974), p. 628; and Gillies (1992), p. 3. A widely read book by Lorsch and MacIver has the colorful title *Pawns or Potentates*. Lorsch and MacIver (1989). Perhaps the most cynical observation comes from an anonymous executive quoted by Leighton and Thain (1997): “Our board is like a bunch of ants... on top of a big log carried by a turbulent current swiftly down a river. The ants think they are steering the log.” Leighton and Thain (1997), p. 51.

Robert Monks, pioneer among shareholder activists, founder of Institutional Shareholder Services (ISS), and well-known author on corporate governance-related subjects, recently expressed his skepticism this way:

There is almost universal agreement that corporate governance in America is failing. There was a large window of opportunity following public revulsion with the scandals of the 1990s. That energy has dissipated and virtually no “real” reform has occurred. We are in the “worst of times”—unignorable evidence of governance failure persists from the comic criminal of Health Care South to the nearly noble Royal Dutch Shell; equally unignorable is the failure on all sides to come up with credible improvement. Instead, companies complain of the cost of compliance with new laws and threaten to tie up proposals in appellate court litigation; reformers complain of the failure of new initiatives. Monks (2005, March), p. 108.

Monks continues,

Similarly, appearance and reality are conspicuously at variance with respect to recent governance “reforms.” So much attention has been paid to such widely discussed “apparent” reforms as the NYSE listing requirements and Sarbanes Oxley (“SOX”) that observers fail to note the fundamental difference between process and substance. Business leaders exacerbate the problem by polluting public dialogue

with complaints of “governance fatigue.” In reality, only a cynic or an incurable optimist could detect real reform in recent enactments. Monks (2005, March), p. 109.

He concludes,

I have recently argued that most of the observed problems of governance failure arise out of the excessive power lodged in the Chief Executive Officers. Persons having power are reluctant to give it up. This is the problem, and this is the challenge. Governance is stuck in the mode of confrontation between owners and managers and the managers have won. The informing energy of business is greed; solutions that are not based in economic incentives will certainly fail. Reform proposals will be credible only to the extent they make desired action profitable. Nothing by way of change will happen unless the various corporate constituencies can achieve profits through compliance. Monks (2005, March), p. 109.

Real change, Monks (2005) argues, should focus on making shareholder responsibility a reality by removing the “many biases in the current legal/regulatory/institutional structure of governance.” Monks makes a number of intriguing, sometimes politically controversial and challenging, proposals, such as placing a tax incentive on term ownership to encourage long-term holding of securities and discourage “churning,” increasing the role of shareholders in the nomination of directors to achieve true director independence, and splitting outstanding common equity into two classes—“ownership” and “trading” shares—to more meaningfully engage institutional owners in the governance process. Calling CEO compensation the “smoking gun” of governance failure, he also urges the restoration of CEO pay to credible levels, even if this means changing existing agreements. Monks (2005, March), p. 110.

Despite all this skepticism, a reasonable argument can be made that the broad evidence is not consistent with a failed U.S. system. On the whole, the U.S. economy and stock market have performed well, both on an absolute basis and relative to other countries over the past 2 decades, even after the scandals broke. And while parts of the U.S. corporate governance system clearly failed under the exceptional strain of the 1990s, the overall system, which includes oversight by the public and the government, reacted quickly to address the problems. On balance, most of the reforms that have been enacted are welcomed. Along with other increasingly common board features—periodic self-evaluation, for example, and requiring that directors own a significant amount of company stock—they have, by and large, had a positive effect on governance and, indirectly, on company performance. This is not to deny that significant issues persist, however.

Perhaps the most visible and contentious unsolved problem is runaway executive compensation. A growing number of investors and directors, upset with absolute levels of pay and with forms of compensation that are not aligned with long-term corporate performance, want concrete change. Shareholder activists are pushing additional reforms. They continue to press, for example, for the right of shareholders to directly nominate and elect directors rather than work with the slate recommended by the board's nominating committee. Another proposal asks that shareholder resolutions receiving majority support become binding upon boards and that shareholder votes on merger proposals be made mandatory. Support for these further proposals has been lukewarm, however, because they tend to undermine rather than strengthen the role of the board.

Others complain that the recent wave of reforms has been too narrow in focus—exclusively aimed at the immediate interests of shareholders—and has not addressed or even seriously contemplated the broader set of stakeholder concerns and societal pressures that is emerging on issues, such as companies' growing political influence, sustainable business practices, and various dimensions of corporate social responsibility.²⁵ In academic terms, reforms enacted to date can be characterized as being primarily focused on addressing the so-called agency problem—the innate conflict that exists between owners (investors) and management, even though managers ostensibly act in the shareholders' interests. For more on this issue, see [Chapter 3 "The Board of Directors: Role and Composition"](#).

Finally, there is a growing concern that the recent wholesale adoption of new rules and processes may have had a number of unanticipated, unintended, negative consequences. Regulation is, and always will be, an extremely blunt instrument for solving complex problems, and impacts different companies in different ways. Many smaller companies, for example, are struggling to cope with the additional regulatory burden and comply with the new law. In recognition of this fact, proposals allowing smaller companies to scale back or postpone compliance with some of the provisions in the Sarbanes-Oxley are now under active consideration.

4.4 The Challenge: Striking a Balance

While no one disputes the need for transparency, honesty, and accuracy, corporate governance is about much more than the accuracy of the income statement and balance sheet. Compliance is a means to an end. The numbers merely summarize and reflect the full array of decisions—from strategy to structure to process—that guide a corporation. Encouraging responsible, responsive governance rather than mere compliance should be the overriding goal and the principal focus of reform. Truly effective boards understand their obligations to shareholders, other stakeholders, and society at large. They grasp the strategic challenges faced by their companies and the role they play in assisting management in seizing competitive opportunity. They also understand the dynamics of the interplay between management and directors, and they value partnership over adversarial relationships without sacrificing independence. And, especially in smaller companies, they alert management to opportunities for growth, assist in raising capital, and provide a sounding board for management on issues of strategy, asset redeployment, and fiscal and legal affairs.

Unfortunately, evidence is emerging that some boards have become even more “defensive” than before in the face of an increased exposure to shareholder and legal action. And, although there is no critical shortage of qualified directors at this time, it is not unreasonable to ask whether the new regulatory environment has made it harder to attract the right talent to serve on boards. It is, therefore, time to ask some penetrating questions: Has the regulatory pendulum swung too far? Do more regulated boards produce greater value? For shareholders? For other stakeholders? For society? Could the additional regulatory burdens reduce business productivity and creativity, or even board assertiveness, especially in smaller firms?

As we start to address these issues, we should realize that there is no unique model for developing a highly effective and responsive board, nor is there a unique model for what such a board looks like, how it organizes itself, or how it operates. It is also unlikely that it can be legislated and regulated into being. As noted earlier, changing the ethics of business behavior and the “sociology” of the boardroom cannot be accomplished through structural changes alone. Instilling ethical behavior and creating a value-creating orientation is fundamentally an internal process that can only be successfully concluded with the complete support of both management and directors. It requires openness to self-examination, a willingness to question individual and collective roles, a resolve to address issues of process, and a receptivity to change.