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FREE ENTERPRISE IN A FREE SOCIETY

An Address by

Harold M. Williams, Chairman
Securities and Exchange Commission

Corporate Governance in the 80's
Jesse H. Jones Graduate School of Administration
Rice University
and
The Forum Club of Houston
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NOTE: This is a final draft of Chairman Williams' remarks. Although this draft may be quoted, the Chairman may make minor revisions during his oral presentation. These alternations, if any, will be reflected in the printed text which will be available from the Commission's publications unit in the near future.

Early this year, we witnessed the passing of one of this Nation's outstanding jurists -- William O. Douglas. Prior to his elevation to the Supreme Court, as you may know, Justice Douglas was an eminent scholar of corporate and securities laws, a member of the Commission's staff, a Commissioner and then its Chairman.

While associated with the SEC, Douglas played a critical role in shaping the future course that the Commission was to take. He oftentimes may have been critical of particular business actions, but Douglas also understood that a viable private business sector is the foundation upon which a free society can best be built. In his memoirs, he wrote:

> "[P]reservation of free enterprise seemed to me to be the best . . . . Free enterprise is not guaranteed by the Constitution, as are free speech and free press. But the First Amendment and free enterprise seemed to me to go hand-in-hand in a practical way." 1/

Most of the private sector, in my opinion, has long recognized the significance of the free enterprise system in maintaining a free and libertarian society. Accordingly, it has fiercely fought many government proposals and programs which it viewed as unwarranted intrusions into its proper domain. Nonetheless, the business community has not adequately recognized a more

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1/ W.O. Douglas, Go East Young Man 307-308 (1974).

subtle occurence -- whose consequences may be more severe to the maintenance of an independent free enterprise sector than any proposal that has been dreamt up by a governmental authority. That problem is the continuing erosion of the public's confidence in our private economic system. Its genesis, in a growing sense, is that business does not adequately balance its interests and the public's, but rather focuses on its own narrow objectives.

The findings of one firm which has done extensive work concerning public attitudes toward business illustrates this skepticism. In 1968, Yankelovich, Skelly and White found that 70 percent of the respondents in a national survey agreed that business tries to strike a fair balance between profits and the public interest. Only two years later, in 1970, that figure had dropped to one-third. It reached a low point of 15 percent in 1976 -- a 55 percent loss of support over eight years. And, it has not recovered significantly in the years since 1976. 2/

If these survey results, and others like them, are an accurate reflection of confidence in our private economic system, then it is not difficult to understand why the

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2/ Yankelovich, Skelly and White, Report to Leadership Participants on 1978 Findings of Corporate Priorities (1979).

political process frequently seems insensitive to measures which would improve the health of the free enterprise system. And correspondingly, it is these kinds of perceptions of business and its leaders which business needs to change.

I. The Issue -- The Accountability of Power

At the outset, it is useful to explore why the accountability of corporate power is an issue in our society today. Quite clearly, the American economic system has propelled us, in less than 100 years, from an underdeveloped, primarily agricultural society, to one of mass wealth and mass consumption. In the process, we have raised the standard of living in much of the rest of the world along with our own. And, most importantly, we have created a society which respects fundamental human liberties. This unprecedented phenomenon is a direct result of our private enterprise system. In the face of this tremendous success, why should any question arise as to the "accountability" of corporate power? A more natural reaction would seem to be, in the words of a former Office of Management and Budget Director, "If it ain't broke, don't fix it."

In my view, the answer to this particular contradiction lies in the fact that we have a deep-seated conviction that anyone who exercises power needs to be accountable to someone else for his stewardship. Most people would, I think, regard it as self-evident that anyone who is not accountable, whose word is final and who is not subject to review and risk of removal for failure to achieve acceptable results, may, over time, become autocratic, arbitrary and arrogant.

Traditionally, two answers have served to alleviate concern over the question of whether economic power is accountable to the public good. The first prong of the response has been that the discipline of the marketplace checks, and ultimately destroys, those who are irrational in the exercise of corporate power. Whatever force it may once have had, however, this hypothesis has lost most of its vitality -- at least for the largest corporations. The difficulty is that the theory presupposes an open economic universe which is no longer the reality. We have substituted for that open universe of free competition a business environment designed to insulate against the hazzards of a 19th Century economy. In fact, what is left of the argument that the discipline of Wall Street will ultimately result in an inadequate management's replacement is being rapidly impaired by corporate defensive measures which, in many cases, effectively eliminate the discipline imposed by the possibility of an unfriendly takeover -- regardless of the performance of management or the price the outsider is willing to pay. Moreover, in exercising such defensive measures, management may refer to its very real responsibilities to persons other than its shareholders -- such as its social responsibilities -- as a reason for resisting a takeover, although until the takeover was initiatied management often did not seem to give such concerns much heed.

The second argument most commonly used to challenge the need for mechanisms of corporate accountability rests on the theory that the board of directors, as the shareholders' surrogate, acts as the watchdog of management power. Again, however, the facts do not adequately support the theory. While the record of board performance is difficult to isolate and study, it shows that directors seldom turn ineffective management out and react exceedingly slow to corporate deterioration. In his testimony before the SEC on September 30, 1977, Myles Mace pointed out that, for example, when boards have fired a chief executive:

> "the leadership of the [incumbent] was so unsatisfactory that even his mother thought he ought [to go] for the good of the company * * * before the board reluctantly moved."

And, this lack of oversight may apply to the growing, as well as the deteriorating, corporation, and to strong, as well as ineffective, management. In my opinion, for example, directors have not been sufficiently diligent in exercising their duty to ensure that large premium payments for acquisitions have an economic justification, and are not merely exercises in business or ego gratification.

In short, what is missing from this environment is a force that has the practical capacity to effectively oversee management, and, if necessary, make timely changes in policy or personnel. To the extent that the public perceives this accountability gap -- and concludes that it has suffered serious consequences because of it -- the pressure mounts for government to step in. I have little confidence, however, in government's ability to be prescriptive concerning corporate mechanisms without also being so oppressive as to destroy them. Thus, in looking for solutions, we need to concentrate on improving the overall effectiveness with which the present system functions rather than experiment with a totally new system of accountability. The issue is how to preserve the advantages of a strong management-based corporate system and still be assured of effective institutional discipline. In my view, the answer is to be found in the corporate board room.

II. The Role of the Board of Directors

A strong and effective board is a valuable corporate asset. Enhancing the perception of corporate accountability and thus reducing the pressure for a government role in corporate decision-making is a vital goal. However, both management and directors also share another, more fundamental, goal -- to develop a board which can bring the best, most informed and most objective advice available to bear in solving the complex problems which confront the entity. If directors are timid or feel compelled to compromise rather than advocate their views forthrightly -- whether because of their personalities, their friendships, or their pocketbooks -- then, in the long run, the corporation is the loser.

In suggesting that an independent source of discipline is missing from many corporate environments, I do not mean to ignore the very real progress which many boards have made. Indeed, some boards already function most effectively, and many others are exploring ways to stregthen their role. The changes that the board is undergoing, or has undergone, have served to protect the basic system and to demonstrate its ability to evolve. I believe the basic sociology of the board room dictates that those companies which have not engaged in a searching examination of the role their boards could play must do so, and that further changes should occur. These changes are, however, within -- not destructive of -- the basic board framework and the independent decision-making upon which the free enterprise system is grounded.

In talks over the past several years, I have made a number of proposals concerning board composition, chairmanship and committee structure which would, I believe, help to counteract these tendencies. The board construction I have proposed addresses what I consider to be the most common and objectively identifiable aspects of board structure and composition which can impede the effective functioning of the board. It obviously cannot deal with the sociology of the board room directly. Nor does it deal with the personal qualities of individual directors, whatever they may be. Yet, ultimately, the effectiveness of the board is determined by the attributes of the directors and by the attitudes and ethics which pervade the board room.

For that reason, rather than repeat my board structure proposals, I want to outline the concerns which underlie them. My objective is to encourage boards to explore the issues and the implications and relevance.

First, it is important to consider the role and number of outsiders on the board. This is not a novel concern. Almost a half-century ago, Justice Douglas offered a description of this problem and a suggestion for a prescription for this problem when he wrote:

> "[B]oards wholly or dominately filled with 'shirt-sleeve' directors drawn from the executive management, without outside representation, are apt to suffer from myopia and lack of perspective. It is one thing to operate a business efficiently, but it is quite another to be sufficiently detached from the business to be able to see it in relation to its competitors, trade trends, and the like. * * * The minimal requirements in this regard are statutory provisions that a board of directors shall be composed of stockholders who are not employees or officers of the corporation * * *." 4/

Today such outside representation means individuals who are neither employees of the corporation or otherwise dependent upon it economically. That definition raises questions as to the status of many persons who have traditionally served as directors, such as corporate counsel, underwriters, bankers, major customers and major suppliers. I am not suggesting that these individuals are necessarily ineffective as directors or that self-interest usually

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4/ W.O. Douglas, Directors Who Do Not Direct, 47 Harv. L Rev. 1305, 1313-14 (1934).

clouds their judgment. As I pointed out earlier, however, the sociological and psychological factors which pervade the board room limits the ability of management members to perform the accountability function. Similarly, the "second hat" which corporate counsel and other "suppliers" of goods and services wear with respect to the corporation raises an issue of whether their ability to contribute to both the reality and perception of accountability is diminished. Stated differently, directors who have business links to the corporation impose a cost on the accountability process, and we need to consider carefully in each situation whether the cost is a necessary one to incur, and whether the benefits can be achieved in another way.

Second, board members need to examine the role of the corporate CEO as chairman of the board. The ties which board members will feel to the CEO and their basic desire to be supportive are compelling. The consequences of adding to that power the power of the chair and of the agenda process must be weighed cautiously. The chairman's role is to create an open, contributing and questioning environment. The CEO's role is to speak for management. These roles and the talents to discharge them are not the same and can conflict.

The final broad issue which boards must consider is the specific responsibilities which the board needs to discharge and how best to approach these tasks. Board committees comprised of outside directors may have an important role to play in the board's satisfying these responsibilities, especially when there are a significant number of insiders on the board as a whole. Special function committees -- such as audit, nominating and compensation committees -- are particularly critical. Audit committees are critical because of the fundamental role which the independent auditor plays in corporate accountability and the special trust which the public places in the auditor's work. With the wide acceptance of the concept of the audit committee, the question which must now be faced is the definition of the committee's responsibilities.

Possibly the most significant special function committee in developing effective corporate boards is the independent nominating committee. I anticipate that within a year most major corporations will have such a committee. For such a committee to be effective, it must concern itself with board composition and organization. It can thus be the vehicle to deal more objectively with the trade-offs between the benefits of, for example, additional management representatives on the board and the costs of those representatives. More broadly, the more important responsibility of the nominating committee should be to develop a process to assess how well the board is functioning, to evaluate the board and its members, and to select criteria for board candidates which mesh with the board's needs. These functions are part of the board's responsibilities to ensure the adequacy of its operations as a body independent from the corporation's management. Such independence is also reflected in the recognition that a directorial slate nominated by the board should not be termed the "management's nominees" when, in fact, they are the board's. In this vein, the Commission's proxy rules now require that board proposals be characterized as being board proposals and not management proposals — that the responsibility be placed where it belongs.

Moreover, an effective compensation committee will also strengthen accountability. In addition to considering the appropriateness of the compensation packages for senior management, such a committee should, for example, examine key management compensation policies to assure consistency with the long-term interests of the company and to assess whether compensation practices encourage management to maximize short-term profit at the expense of the longer-term best interests of the corporation. Too often this is the case and the board should not be too surprised at the fallout of the conduct it motivates. Another aspect of this committee's mandate should be to consider the level of director remuneration. The nonmonetary rewards of these posts, such as the prestige and the desire to do the board or its chairman a "favor," are not now as compelling -- particularly when weighed against the increasing time demands and risks of liability and other legal entanglements.

Additionally, depending upon the corporation and the particular circumstances, there may be need for other special function committees -- sometimes, even on an ad hoc basis. For example, when a corporation is the target of an acquisition attempt, there may not be a unity between the interests of incumbent management and those of the corporation and its shareholders. There is need in such situations for a special committee of independent directors which would, of course, address the offer in terms of its economic sufficiency. But such a dollars-and-cents analysis should not end its inquiry. For example, it should examine the likely effect of accepting the offer on the ongoing existence of the corporation. And, whether accepting the offer would be in the best interests of long-term investors as well as short-term speculators. Moreover, the committee should look at the reasonable interests in the corporation's independent existence of persons other than its shareholders -- for example, its customers, suppliers, employees and the communities in which it operates. Another important, but often overlooked, role of such a committee would be to monitor the statements and actions of its own management and counsel in response to the offer in what is often a very stressful period.

Before I turn briefly to the role of management in the accountability structure, I want to outline what I do not advocate for the board. First, I do not favor constituency directors. In my view, the board is not a political body and cannot function effectively when populated by individuals who have special interests to champion and little concern or sense of responsibility for the overall welfare of the company. Additionally, some of those who advocate constituency directors seem to have in mind persons unconcerned with -- or actively hostile to -- the basic economic purpose of private business.

Second, I do not endorse or intend to convert the board room into an arena characterized by distrust of, or suspicion toward, management. The goal is an environment of accountability, not one of hostility. A chronically adversarial relationship between board and management would be equally as destructive of accountability as is a relationship characterized by board passivity. The board and management must be capable -- within the accountability framework -- of working with, not against, one another.

Third, I oppose federal legislation or regulatory action to charter corporations, to dictate board structure or even to impose my own suggestions. My goal is to underscore the responsibilities of corporate boards and how they might better carry them out so as to be more effective, strengthen the case against legislation, and make it unlikely -- not to hasten its passage. While some apparently believe that legislation is the key to reform, I am concerned that federal encroachment into the board room would likely cripple rather than strengthen its functioning.

Finally, I am not suggesting that the board's power over corporate business expand at the expense of management's. The appropriate and most productive function of the board is to monitor, not to manage -- to support, to guide and, where necessary, to discipline, but not to usurp. To the extent that effective functioning of the board cuts back on management autonomy, the board is assuming a role it had previously abdicated, and is not usurping a management prerogative.

III. The Role of Management

I want now to turn to corporate management. In considering the role of management, it is crucial to recognize at the outset that management's primary mission is economic and that the key to the success of any corporation is the capability of its management to carry out that mission. The purpose of the corporation is to provide customers with goods and services at an attractive level of quality and price. The profitability of the corporation is, over the long term, a measure of its success in discharging that underlying responsibility, rather than an end in itself. The profitability of corporations as a group is a measure of our society's success in providing jobs, goods, services, prosperity and other economic underpinnings of the political freedoms which make our democracy possible.

How can managements reconcile their profit objectives and the need for the kind of accountability of which I spoke earlier? Simply stated, good management, concerned for the future of the company, achieves a harmony of profit and other goals; indeed, in my judgment, there is a very strong correlation between companies which think and respond in terms of longer-range corporate responsibilities, including social and political overtones, and those with the best performance records over time. Moreover, it is impossible to separate the social environment of the firm from the ethical standards of the executives who manage it. The executive inevitably finds that his own moral code is the bottom line in his business decision-making, or should be, and it is not realistic, either psychologically or ethically, to expect the individual executive's actions as a businessman to be inconsistent with his personal sense of responsibility to society-at-large and to his own conscience. To contend that one can live a personal life by one set of ethical standards and a business career by another is either self-deception or hypocrisy. And, in any event, society will not accept or permit such a distinction.

Management and the board, however, frequently and unwittingly create a climate that tempts subordinates to compromise their ethics -- not ostensibly on their own behalf, but on behalf of the company and the company's measurement of performance. A company, in order to be prudent and moral, must be careful to avoid