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News Release

Remarks to
The Conference on the Fiduciary Responsibilities
of Institutional Investors
New York University

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*/ The views expressed herein are those of Commissioner Lochner and do not necessarily represent the views of the other Commissioners or the Commission staff.

Thank you, and good afternoon.

My topic today is corporate governance, and, in particular, the proper functions and composition of boards of directors.

This topic is by no means new. The current discussion has its origins in the government investigations into illegal corporate campaign contributions, as well as foreign bribes, which began nearly twenty years ago. Before those investigations were over, more than 400 firms --- including the likes of 3M, American Airlines, Goodyear, and Gulf Oil --- were either convicted of, or voluntarily disclosed, making illegal payments.

In the vast majority of these cases, as far as we can tell, non-management members of the boards had little or no idea that the companies they directed were making illegal payments. One outcome of the illegal payments scandal of the early and mid-70's was a series of proposals to reform corporate governance. These proposals, in turn, had their origins further back in corporate history. They continue to be debated today.

Among the proposals for reform was one by former SEC Chairman

William Cary, who proposed enactment of federal minimum standards for corporations. Ralph Nader and his associates went one step further, and proposed that all major corporations be federally chartered. Other proposals were made as well.

A number of events cooled the flames of federal intervention. One was gradual but substantial improvements in boards of directors as governing institutions. Another was the Reagan revolution, with its emphasis on deregulation. However, criticism of corporate boards persists.

What I would like to do today is focus a bit on what we think boards should do and what they actually do, and then, more importantly, raise suggestions, as well as questions, about how we might improve corporate governance. What I want to focus on is not the legal responsibilities of boards, but certain practical issues.

Myles Mace, in his seminal book "Directors: Myth and Reality", identified three generally accepted roles for boards:

1. Boards establish basic objectives, corporate strategies and broad policies for companies;

2. Board members ask discerning questions of management, which require management to support its recommended policies; and

3. Boards select the CEO.

Others have added to the list, and it is possible to reformulate the list in a variety of ways, but it is sufficient for our purposes.

Professor Mace argued that for many boards, these generally accepted roles were more myth than reality. His interviews with CEOs and directors provided evidence that many boards supplied little or no independent oversight.

For example, on the issue of board approval of corporate strategies and plans, one company president said the following, and I quote: "There is absolutely no point in asking a board of directors for approval of capital expenditures. It would be a waste of their time and mine. What contribution could any outside director make?" End quote.

An outside director, when asked why boards do not ask

discerning questions, gave this as an explanation, and I quote: "I, as an outside director, am unwilling to show my lack of a grasp of understanding of the problem or to display my ignorance." End quote.

Now these examples, which are in any event quite old, by no means represented all boards then. I believe they represent current reality even less so. In part in response to criticism of the last decade and a half, significant change has taken place in many of America's boardrooms.

Spencer Stuart, the executive search firm, conducts an annual survey of the boards of 100 major companies. Its 1989 survey confirms the trend, for example, toward smaller, more independent boards. Other evidence is in accord, at least among many of the largest companies, and those most in the public eye.

Indeed, I believe that responsible boards that exercise independence in overseeing management are the rule rather than the exception.

But despite changes, many still charge that boards are

captured by management. The book Pawns or Potentates is but one example of the critical literature. According to the critics, the inside directors who sit on boards are naturally reluctant to disagree with their bosses, and certainly would never criticize their superiors in the presence of outsiders. Critics also view outside directors with suspicion. They charge that outside directors are typically friends or business associates of the CEO, and therefore rarely exercise any independent judgment.

Others argue that the debate over insiders versus outsiders and the need to restructure boards is much ado about nothing. They have a view that can perhaps be best described as laissez-faire. They contend that the takeover mania of the 80's created the ultimate weapon to punish boards that fail to insist on maximizing shareholder value.

I believe it is simple-minded and short-sighted to think that external market forces can cure all shortcomings in corporate governance. First, as we all know, the takeover threat of the '80's has sharply subsided. Second, reliance alone on the market

for corporate control can result in abrupt and rough justice at best. At worst, it is no justice at all.

The latest vogue is proxy contests, with particular emphasis on the purported power of institutional shareholders. Some argue that institutions as a group can and will exercise significant control over corporate affairs by nominating their own board slates.

While it is true that institutions hold a substantial share of corporate equity, it is wrong to view the thousands of companies that invest on behalf of their beneficiaries as a single body speaking with one voice. For instance, among the various entities lumped together as institutional investors are private pension funds, public pension funds, investment companies, insurance companies, foundations and endowments, and banks acting as trustees for individuals and other entities.

Each of these institutional shareholders has its own investment policies, its own views of corporate governance and varying power over the assets it manages. Some see themselves as

long term investors; others, quite rationally, do not. These differences, along with others, influence different institutions' decisions on whether and when to acquire or dispose of securities, or how to vote proxies. Given the variety of differences among institutions it seems unlikely that institutions, acting alone or as a group, will reform corporate governance through proxies or shareholder proposals.

Nor is it clear that changes in the proxy rules will have much effect on corporate management, other than the crudest such effects.

Furthermore, it is not clear that institutions necessarily want hands on involvement in corporate governance through representation on boards. Institutional representatives on boards might find certain board responsibilities to be incompatible with their fiduciary duty to act for the sole benefit of their institution's beneficiaries. Moreover, constituency directors on boards may tend to create factions, and may dilute the duty of care that each director owes to all shareholders of the corporation.

In the end, institutional investors have the same principal interest as individual shareholders, maximizing the return on their investment. This is best achieved through independent boards that effectively monitor management performance.

I think that in order to improve corporate management, we need to focus more on the board itself, rather than tender offers and proxy fights.

I start from the premise that boards can serve a very valuable function in governing corporations, and that other factors -- other than the discipline of the market for a company's goods or services, or the self-discipline of managers -- are unlikely to have much impact on creating good corporate management. If this is true, then the real question is what makes a board "good"? What makes it work effectively?

The Treadway Commission of 1987 articulated new standards for audit functions for U.S. corporations. Perhaps we need a Treadway-like commission to study corporate boards and propose recommended standards that will help define what constitutes responsible board

governance.

The mission of such a commission would not be to set hard and fast rules or to create standards for legal liability. I believe it is difficult, at best, to legislate good boards into existence. Nor can you easily compel good board behavior through the threat of legal liability --- all you can do is avoid the worst sort of board behavior. Rather, a Commission on Corporate Boards of Directors could seek to create a consensus on the minimum criteria necessary for the functioning of a board by drawing on the wealth of experience concerning how well run boards operate. Such a Commission could comfortably encompass representatives of a variety of organizations --- from the Business Roundtable to CalPERS --- and I suspect there would be a great commonality of views about boards. What I would hope to encourage is constructive dialogue concerning boards, rather than confrontation.

Let me suggest the range of topics on which such a Commission might usefully report. I want to take a minute or two on each topic, without necessarily concluding that there is a single right

answer on any topic.

Board Size

What is the optimal size for a board of directors? It is difficult to conceive that a board of 30 persons could do its job effectively, barring unusual circumstances. But at least some boards of that size appear to perform credibly. In the last decade, median board size has shrunk from 16 to 14. Many believe that boards should be smaller still. The conventional wisdom is that very large boards stifle debate and dissent, while smaller boards promote livelier discussion among their members. On the other hand, some social psychology research on small group behavior suggests that very small groups tend to generate interpersonal relationships which may be very effective in getting things done, but may also just as effectively stifle debate.

These, it seems to me, are questions worth addressing by a Commission on Corporate Boards.

Number of Board Meetings

How often should boards meet? The trend has been toward more

board meetings, and it is difficult to believe that a board could be effective if it met fewer than a half dozen times a year. One significant variable in deciding board meeting frequency may be the type of business the company in question is involved in. Strategies and cash flows may change rapidly, for example, for a toy or a clothing company, whose products are subject to fickle consumer tastes, as opposed to an electric utility, whose business may change more slowly. Presumably the board of the toy company should be expected to meet more often than that of the electric utility. One might also argue for more board meetings for multiproduct companies than for single product enterprises, on the theory that there is more to watch over. Furthermore, a larger company might require more board meetings so as to create the opportunity for directors to delve more deeply into its operations.

Board Composition

What should the ratio of outside to inside directors be? The conventional wisdom is that a majority of the directors should be outsiders for the board to oversee management effectively. But are

any inside directors, beyond the CEO, necessary except in unusual circumstances? Although directors may need access to management to provide the board with important information concerning various aspects of a company's operations, this information might be easily conveyed to the board without managers being directors. These are also questions which a Commission on Corporate Boards could study.

Independence of Outside Directors

Weighting boards in favor of outside directors accomplishes little unless the outsiders are truly independent of management. Because outside directors have affiliates which not infrequently do business with a given company, legitimate questions arise over whether such directors are independent. For instance, can a company's lawyer, investment banker, or commercial banker effectively exercise the oversight function expected of an outside director? Can a significant supplier or customer?

Can any director be considered independent if he or she is being paid anything other than standard board fees by the company? Or if he or she is related by blood or marriage to a member of

management? If the CEO of Company X sits on Company Y's board, should the CEO of Y sit on X's board?

The American Law Institute's draft on corporate governance suggests that a majority of directors should not have any "significant relationship" with any of the company's senior executives. The ALI defines a significant relationship as including any employment with the company within the last two years, or commercial payments to or from the company in excess of $200,000. My personal view is that the dollar threshold may be too high and the rule should be extended beyond a mere majority.

Board Committees

Increasingly, the important work of the board appears to be performed at the committee level. What committees should a board have in addition to the audit committee? A nominating committee? A compensation committee?

The composition of these committees is also an important issue. Many argue that these committees should only have outside directors because the presence of insiders creates an inherent

conflict of interest. For instance, can a nominating committee select truly independent nominees if the CEO is a member of the committee? And what compensation committee can openly debate an executive's worth if he or she is sitting in the room?

A Director's Commitment of Time

Boards do not adequately supervise if board members fail to devote enough time to the job. A board member who sits on fifteen boards is unlikely to be able to do justice to any of them.

Even if a director has no other responsibilities he or she needs to be committed to the job of director. In short, a director needs to spend time on the job. While it is true that boards cannot and should not attempt to micromanage companies, board members should be expected to take the time to understand the company's business. It may make sense, for example, for companies to have a day-long meetings, in addition to regular board meetings, to review significant aspects of the business in detail. Also, why not let the board or its committees hire independent consultants where appropriate to aid it in their review?

Essential Board Functions

Another way to improve the effectiveness of boards might be to offer guidelines on certain activities that all boards should perform. A Commission on Corporate Boards could develop a list of those minimum activities which a board should perform each year. For instance, boards should approve all major expenditures, which could be defined to include expenditures which meet or exceed a certain thresholds. Similarly, boards should, of course, review the annual operating and capital budgets.

Another basic duty of a board involves the selection and retention of key management. The most limited resource for any company is not capital. It is, instead, qualified personnel. A board should make sure that management has a process in place to recruit and develop talent. Should boards also conduct or review legal, environmental and other compliance audits? What other activities should a well run board engage in?

Executive Compensation

An important area of board oversight is executive

compensation. The conventional wisdom is that executive compensation has reached stratospheric levels. But before we decide to slash executive pay it might be worth noting a study by Harvard's Michael Jensen, which shows that 50 years ago the average salary and bonus for executives of leading companies on the New York Stock Exchange was $882,000 in today's dollars. In contrast, for the period 1982 through 1988, the average salary and bonus for executives of comparable companies was only $843,000.

Our preoccupation with how much so and so is paid obscures a more fundamental question -- is so and so worth what he is paid? Professor Jensen argues that boards are intimidated by the public's focus on salaries and consequently are reluctant to reward executives sufficiently for outstanding performance. The result of this risk-averse approach by boards is a compensation system that in many cases has little relation to performance and offers few incentives to either overachievers or underachievers.

The most frequently mentioned solution is to tie executive pay to company performance. Many argue that another important

incentive would be to increase the percentage of compensation received as company stock by a significant amount. This approach obviously gives management very direct feedback on the company's performance. On the other hand, stock ownership might make management too attuned to short term performance, to the detriment of long range planning. In any event, the various pay for performance proposals certainly merit serious consideration.

Board Compensation

A Commission on Corporate Boards could review the related area of board compensation. Certainly if we expect boards to devote more time to their duties they must receive commensurate pay.

Another issue is the legal liability that directors face. On this issue I believe that directors need significant protection from legal liability. It is difficult enough to find qualified men and women to serve without subjecting them to the random jeopardy of the strike suit bar. We don't want boards which are simply terrified of taking risks.

Limiting the Length of Board Service

Finally, a Commission on Corporate Boards could explore whether board members should be required to step down from the board after a certain number of years of service. Obviously, board member tenure should be long enough so that continuity of oversight exists. But, outside directors who serve on boards too long may become less effective. A veteran director may perceive the present status of the company as a product of his efforts, and be less open to change. A mandatory turnover of directors may promote independence, and assure that fresh perspectives are brought to the corporate board on a regular basis.

CONCLUSION

The imposition of rigid rules for corporate governance may be inappropriate for institutions that vary enormously and change frequently, such as our over 13,000 public companies. But few would argue that there is room for improvement in many boards of directors. The best way for the business community to avoid the imposition of rigid rules is to lead the way by example, to set

higher standards for boards of directors. A Commission on Corporate Boards may help focus attention on proper board structure and performance. I am confident we can improve corporate governance, if we give it the priority it deserves.

Thank you.