

U.S. Corporate Governance: What Went Wrong and Can It Be Fixed?

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Paper prepared for B.I.S. and Federal Reserve Bank of Chicago conference,
“Market Discipline: The Evidence across Countries and Industries”,
Chicago, Oct. 30 – Nov. 1, 2003

I. Introduction

The front-page corporate scandals that erupted in the U.S. economy beginning in 2001 – Enron, WorldCom, Tyco, Adelphia, HealthSouth, and others – have undermined confidence in the U.S. business system and raised questions about the effectiveness of corporate governance in the United States.¹ While some may see these scandals, and the related financial irregularities, as simply the products of a few dishonest or unethical corporate managers caught up in the collapse of the stock market bubble that began in 2000, the pervasiveness of the corporate misconduct suggests otherwise – that there was a massive failure of U.S. corporate governance to prevent this corporate misconduct. This paper, therefore, seeks to determine why this failure occurred and what can be done to improve our governance system.

Public confidence is directly related to the effectiveness of corporate governance. Not surprisingly, public distrust of corporate executives has increased sharply in the last few years for several reasons. One of these is the egregiously excessive CEO compensation paid to many CEOs, especially to those presiding over poorly-performing firms with collapsing stock prices. In 2001 Larry Ellison, CEO of Oracle, received \$706 million from stock options as his software company sputtered and its stock fell precipitously. Soon afterward the disclosure of the large perks given to GE's former CEO Jack Welch made front-page news, reinforcing a growing distrust in the motives of corporate managers. Then there was Jeffrey Barbakow, CEO of Tenet Healthcare, who made \$190 million in the fiscal year ending mid-2002, during which time much of his firm's earnings was being generated by a massive Medicare fraud perpetrated by Tenet

¹In the twelve months prior to May 2003 a Lexis-Nexis search, using the words “corporation” and “scandal” in the same paragraph, turned up 565 articles in the New York Times alone – almost two a day. In the twelve months preceding that there were only 74 instances. Also, three corporate whistleblowers were Time magazine's “people of the year.”

Healthcare. And even more outrageous, if possible, was the \$71 million paid to Dennis Kozlowski, Tyco's former CEO, while he was allegedly looting Tyco of some \$600 million.

The final coup de grace, perhaps, was the recent and embarrassing disclosure of New York Stock Exchange's CEO Dick Grasso's lofty compensation structure and his subsequent forced resignation, putting the NYSE own governance structure in the spot light – particularly troubling given the central role that the NYSE plays in determining and regulating the corporate governance standards of major corporations.

Repeated incidences of corporate “reporting failures” have also contributed to creating public distrust. Earnings restatements increased markedly during the past ten years. In the two-year period 2000-2001 there were 426 earnings restatements by publicly traded companies, compared to only 43 a year during the period 1990–1997.² Has earnings management (or manipulation) become an integral part of the U.S. business culture, and can business executives be trusted to tell us the truth? A recent Gallup poll of how the public views CEOs of large U.S. corporations is hardly reassuring: CEOs were rated slightly ahead of car dealers in public trust, and well below military officers.³

Whether one believes that our system of corporate governance, whatever its current problems, is still better than that of any other country, the questions raised by recent corporate scandals nevertheless deserve answers.⁴ The social and economic returns to good corporate

²Moriarty and Livingston (2001), and Huron Consulting

³CNN/USA Today/Gallup Poll, July, 2002.

⁴Holmstrom and Kaplan, “The State of U.S. Corporate Governance: What’s Right and What’s Wrong?” *Journal of Applied Corporate Finance*, Vol. 15, no. 3, Spring, 2003; and Diane Denis and John McConnell, “International Corporate Governance,” ECGI Working Paper no. 05/2003, January, 2003.

governance are high, so it behooves us to improve our corporate governance wherever we can.⁵ Recent corporate scandals are a catalyst to do this. This paper reviews the different corporate governance mechanisms employed in the United States to determine why they failed to prevent the recent corporate misconduct and what can be done to improve their effectiveness. A fundamental aspect of this review will be to examine the motivations and incentives of participants in our corporate governance system to determine whether these incentives are aligned with those of shareholders and investors, and, if they are not, to determine whether remedies can be fashioned to more closely align these interests.

II. The Structure of Corporate Governance in the United States

Corporate governance in the United States is comprised of multifaceted legal and institutional mechanisms designed to safeguard the interests of corporate shareholders and to reduce the agency costs that derive from the separation of ownership (shareholders) from control (managers and/or controlling shareholders). Some of these mechanisms seek to increase the information available to shareholders so that shareholders can monitor corporate managers and enhance market discipline. Others seek to protect shareholders by imposing liability on the agents of shareholders (managers and directors) and penalizing them for engaging in activities counter to the interests of shareholders. Still others work through incentivizing managers and other governance participants to pursue the same interests as shareholders. The overriding question, of course, is how all of these governance mechanisms simultaneously failed to protect us from the massive corporate corruption and mismanagement that surfaced during the past few years.

⁵Gompers, Ishii, and Metrick, "Corporate Governance and Equity Prices," Working Paper, Harvard Business School, 2001.

What are the “corporate governance” mechanisms in the United States? A first line of defense is our basic legal structure consisting largely (until Sarbanes-Oxley) of state-based corporate law and federal securities laws. Federal securities laws seek to empower shareholders by requiring enough corporate disclosure to make the operations of corporations transparent to shareholders. If shareholders come to believe that a company is being managed improperly or inefficiently, they can decide not to buy the company’s stock or to sell it if they already own it. Either way, badly performing managers are subjected to “market discipline” which may change the way that they choose to manage their companies. Federal securities laws also empower shareholders to sue fraudulent managers.

In addition, federal securities law provides a proxy voting system that empowers shareholders to elect corporate directors and to impose their collective will with respect “material” changes in the organization or operations of the company. The proxy system, however, is typically not cost-effective for shareholders who hold only small stakes in the company.

Corporate law is a second line of defense. State law and the certificate of incorporation endows corporations with perpetual life and establishes a governance structure for the corporation, assigning rights and duties to shareholders, directors and managers. These rights and duties, as interpreted and honed by a long-line of court cases, have resulted in managers and directors (and controlling shareholders) owing various fiduciary duties to shareholders – specifically, duties of care, loyalty, and candor. Breaches of these duties can result in shareholder suits against managers and directors to stop certain actions from occurring (such as the sale of the company) or for damages stemming from actions that were not in the interests of

shareholders. State corporate law, therefore, attempts to better align the interests of managers and directors with those of shareholders by imposing various obligations on managers and directors and then penalizing them if they fail to meet those obligations.

A third governance mechanism is executive compensation. Shareholders and their elected directors may choose to employ an incentive compensation structure for both managers and directors that better aligns their interests with those of shareholders. In particular, executive compensation has been increasingly tied to the company's stock performance by granting managers either stock options or restricted stock.

Prior to the 1990's very little use was made of equity-based compensation schemes, but during the 1990's equity-based pay, and particularly stock options, increased dramatically. Of the \$11.2 million increase in *average* CEO pay during the 1990's (from \$3.5 million in 1992 to \$14.7 million in 2000), stock options valued at the time of the grant alone accounted for \$6.4 of this amount (stock options grew from \$800,000 to nearly \$7.2 million). By 1999, 94 percent of S&P 500 companies were granting stock options to their top executives, and the grant-date value of these options accounted for 47 percent of total CEO compensation. Further, stock options were given to a broad range of executives and employees. This stands in sharp contrast to executive pay packages in other countries, which have typically employed far lesser amounts of equity-based pay.

Supplementing the foregoing governance mechanisms are two "market disciplinary" mechanisms: "gatekeepers" and "hostile takeovers." The term "gatekeepers," broadly viewed, has come to mean the auditors, credit rating agencies, securities analysts, underwriters, and lawyers who protect the interests of shareholders by monitoring the

corporation and corporate insiders, and by “certifying” the accuracy of corporate reporting and the legality of corporate behavior. Gatekeepers can be thought of as independent, skilled, professionals who are interposed between the corporation and investors and who perform a certification function imposed either by the law (such as auditors) or by market convention (such as securities analysts). A firm that fails to obtain the requisite “certifications” is penalized by being denied full access to capital markets.

According to conventional theory, we can rely on gatekeepers to perform these roles honestly and effectively because they are independent of the corporations they monitor and because their business success depends critically on their credibility and reputation. The desire to build and maintain a strong reputation with investors and creditors, arguably, aligns the incentives of gatekeepers with those of investors and creditors, rather than with those of corporate managers. In addition, the threat of private litigation deters gatekeepers from fraudulent or reckless behavior.

Hostile takeovers, in theory, are the ultimate market response to corrupt or inept management and a failure of other corporate governance mechanisms to correct these problems. Takeovers replace entrenched and inept managers with new managers capable of increasing stockholder value, and typically introduce new measures to align manager interests with those of shareholders (such as incentive compensation schemes). Hostile takeovers, however, are usually costly because by definition they encounter stiff resistance from entrenched managers and because the law permits entrenched management to erect formidable takeover defenses. Thus, a hostile takeover is a viable option only when agency costs are especially large. Nonetheless, the mere threat of a hostile takeover may be a significant deterrent to lazy and inept managers.

There is also the possibility that hostile takeovers can be used to “greenmail” companies rather than to increase efficiency. Thus, while hostile takeovers are undoubtedly an important component of an effective system of corporate governance, they provide only a crude check on incompetent or fraudulent managers.

III. What Went Wrong?

Most of the recent corporate scandals are characterized by either the willingness of corporate managers to inflate financial results, either by overstating revenues or understating costs, or to divert company funds to the private uses of managers (i.e, to loot the company). Prominent examples of fraudulent “earnings management” are WorldCom’s intentional misclassification of as much as \$11 billion in expenses as capital investments – perhaps the largest accounting fraud in history; Enron’s creation of off-balance sheet partnerships to hide the company’s deteriorating financial position and to enrich Enron executives; and HealthSouth’s overbilling of Medicare and fraudulent accounting practices. Examples of just plain looting are Adelphia and Tyco, where top executives allegedly stole millions of dollars from their companies and then tried to cover it up.

If nothing else, the pervasiveness of this kind of managerial misconduct raises fundamental questions about the motivations and incentives of American business managers and about the effectiveness of American corporate governance.

1. Is there a fundamental misalignment of managerial and shareholders interests in the United States, and, if so, what are the causes of this misalignment? Or, stated somewhat differently, does the incentive structure that American managers typically face motivate them to

engage in the kind of financial fraud and earnings mismanagement that has characterized recent corporate scandals, and what is the source of this perverse incentive structure?⁶

2. Why did internal governance mechanisms, such as corporate boards, audit committees, and compensation committees) either condone or, more likely, fail to penetrate the fog of misinformation and fraud that shrouded managerial misconduct and allowed managers to deceive shareholders and investors? Are the incentives of board members the same as those of shareholders, or are they conflicted in significant ways?

3. Why did external gatekeepers (such as auditors, credit rating agencies, and securities analysts) not 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. Finally, why were not shareholders themselves more vigilant in protecting their interests, especially our large institutional investors? What are the motivations and incentives of money managers?

A. Managerial Compensation and Earnings Misreporting

Why do managers engage in earnings misreporting in the short-run when they know that the true state of the company's operations must eventually be revealed, either by the collapse of the firm or by their inability to continue to deceive investors? Further, why has the incidence of misreporting increased during the 1990's? There must, obviously, be benefits that managers can reap in the short-run that make such deceptive behavior rationale. An obvious benefit of misreporting is that managers get to keep their jobs longer, but this benefit existed long before

⁶By earnings mismanagement I mean not only reporting that is illegal or inconsistent with accepted accounting standards but also statements that while within accepted legal and

the 1990's and probably does not explain the increased incidence of misreporting during the 1990's. I believe the answer is that the benefits from misreporting increased substantially during the 1990's, and therefore the incentive to misreport was greater, because of the dramatic change in the compensation structure of American executives.

In particular, in 1989 only 4 percent of the median CEO pay of the S&P 500 industrial companies was equity-based – 96 percent was salary and cash bonuses. By 2001, equity-based pay had jumped to 66 percent of the median CEO compensation.⁷ Further, a greater use of stock options by companies accounts for most of this increase in equity-based pay. As a consequence, the sensitivity of CEO pay, as well as that of other executives, to short-term corporate performance increased sharply in the 1990's. Further, as stock price climbed during the 1990's, executives were able to exercise these options and sell stock to take advantage of favorable company performance. Thus, the incentive to continue to report (or misreport) favorable company performance was substantial, so long as executives held options that could be exercised and the stock sold to take advantage of favorably reported company performance.

Equity-based pay is certainly part of the Enron story. The compensation of Enron executives was closely linked to shareholder value, and executives had a substantial portion of their compensation at risk (as much as 70 percent according to Enron's own compensation committee report). As such, Enron executives clearly had a strong incentive to make every effort to increase earnings and the company's stock price. While this may arguably result in a better alignment of interests of managers and shareholders, it may also have the unintended effect of creating strong temptations for managers to engage in transactions that circumvent accounting

accounting standards are primarily meant to deceive investors about the company's true financial condition.

⁷Hall and Murphy (2002).

rules and misrepresent the financial condition of the company in order to boast the company's stock price.

One implication of the recent corporate scandals, therefore, is that we may want to revisit how we are using equity-based compensation to motivate managers, and, in particular, whether a different pay structure could be used that mitigates or eliminates the associated incentives for managers to misreport. While the rationale behind equity-based compensation is sound – to motivate managers and better align manager and stockholder interests, there may be better ways to structure pay packages. In particular, we might make more use of “restricted” stock to prevent managers from taking advantage of short-run events (for example, options holders could receive restricted stock), increase the transparency of executive pay packages through greater disclosure and more sensible accounting treatment of stock option grants (i.e., expensing them in financial statements), and provide prompt disclosure of stock selling by managers so that the market can better assess the motivations behind such selling. In addition, stricter accounting standards that reduce the ex ante opportunities to engage in misreporting would also help to curb misreporting, as would a requirement that companies and their auditors have to report a “true and fair view” of the company's financial condition.⁸

B. The Performance of Corporate Boards

Why have corporate boards not been more alert to the kinds of managerial behavior that brought about recent corporate scandals? Again, Enron is illustrative of the problem. As boards go, Enron's was a “Dream Team,” stacked with sophisticated and distinguished individuals, and with experts in finance, investing and accounting. Its directors had significant ownership stakes

⁸See Benston and Hartgraves, “Enron: What Happened and What We Can Learn From It,” Journal of Accounting and Public Policy, 21 (2002), 105-127.

in Enron as well, so their interests should have been aligned with those of Enron's shareholders.⁹ Its 14-member board had only two internal executives, Chairman of the board and former CEO Kenneth Lay and President and CEO Jeffrey Skilling. The other twelve directors consisted of five CEOs, four academics, a professional investor, the former president of Enron's wholly-owned subsidiary Belco Oil & Gas (an affiliated director), and a former U.K. politician. On paper, at least, 86 percent of Enron's board might be considered to be "independent," considerably higher than for most U.S. companies.¹⁰

Enron's board structure also was everything one could have wanted: subcommittees for compensation and management development, audit and compliance, nominating and corporate governance, and finance, and these committees were all comprised of outside directors (except for the finance committee which had one affiliated director). In addition, the audit committee had a state of the art charter making it "...overseer of Enron's financial reporting process and internal controls..."; had "...direct access to financial, legal, and other staff and consultants of the company"; and had the power to retain other (outside) accountants, lawyers, or whatever consultants that it deemed appropriate.¹¹

Even the corporate culture at Enron seemed ideal. In a 1999 speech on the Conference on Business Ethics, Chairman Kenneth Lay said:

⁹The beneficial ownership of the outside directors reported in the 2001 proxy ranged from \$266,000 to \$706 million. See Gillan and Martin, "Financial Engineering, Corporate Governance, and the Collapse of Enron," WP 2002-001, Center for Corporate Governance, U. of Delaware, p. 23.

¹⁰See Enron's proxy statement, May 1, 2001. Subsequent to Enron's collapse, the independence of some of Enron's 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.

¹¹See J. N. Gordon, "What Enron Means for the Management and Control of the Modern Corporation: Some Initial Reflections, U. of Chicago Law Review (2003)

“A strong independent and knowledgeable board can make a significant difference in the performance of any company. ... It’s not an accident that we put strength of character first. Like any successful company, we must have directors who start with what is right, who do not have hidden agendas and [who] strive to make judgements about what is best for the company and not about what is best for themselves or some other constituency.”

Yet detailed examinations of what happened at Enron after its collapse arrived at conclusions about board performance strikingly at odds with the picture painted above. The Congressional Subcommittee on “The Role of the Board of Directors in Enron’s Collapse” concluded that there was a fiduciary failure of the board (a breach of its duties of care, loyalty, and candor?) because it allowed Enron to engage in high risk accounting, inappropriate conflict of interest transactions, extensive undisclosed off-the-books activities, inappropriate public disclosure, and excessive compensation.¹² And the Powers Report concluded that “The board cannot be faulted for failing to act on information that was withheld, but it can be faulted for the limited scrutiny it gave to [many] transactions, [such as those] between Enron and the LJM partnerships.” (p. 148)

Whether or not these are fair assessments of the board’s performance, Enron does make clear that in an environment of high-powered equity-based compensation schemes combined with opaque financial disclosure policies, which can create strong incentives to manipulate financial results, boards must be especially diligent about monitoring financial results and financial controls, and about monitoring and approving transactions where there are actual or potential conflicts of interest. It is fair to say, I believe, that the Enron board did not meet this higher standard of care.

Why did the Enron and other corporate boards fail? And can we do anything to prevent this from happening against? Sarbanes-Oxley and the NYSE new governance rules seek to improve board performance by increasing the independence of boards and by requiring them to follow more specific processes and procedures to assure that they act responsibly and independently. Specifically, the definition of “independence” has been tightened in an effort to eliminate conflicts of interest among board members, and there are new requirements that both boards and key board subcommittees must be comprised of a majority of independent directors. In addition, to enhance market discipline greater disclosure is now required of off-balance sheet arrangements and other transactions that have obfuscated company financial statements and mislead investors.

In short, Sarbanes-Oxley reforms have in effect codified and given teeth to what was generally viewed as “best practice” prior to the recent corporate scandals, and by doing so, I believe, has already changed the corporate culture about what board responsibilities are and about what a good boards and directors need to do. It will probably also increase director liability for misconduct in the future. This can only help to narrow the scope for corporate misconduct in the future. It remains to be seen, however, whether Sarbanes-Oxley will succeed in changing the traditional culture of collegiality and the “go along” atmosphere that pervaded most corporate boards in the past, and which Warren Buffett, in his annual letter to Berkshire Hathaway shareholders, summed 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.”¹³ I

¹²Permanent Subcommittee on Investigations, Committee on Governmental Affairs, United States Senate, July 8, 2002.

¹³USA Today, 3/31/03

think Sarbanes-Oxley has a good chance of changing this culture. But I would go even further than Sarbanes-Oxley and separate the jobs of CEO and Chairperson of the Board, and require that the board be chaired by an independent director.

C. Gatekeepers

It is also important to increase market discipline of corporations. While greater transparency – better accounting rules and disclosure – is an essential part of this goal, it is equally important that information be used effectively to further the interests of investors and shareholders. Making “gatekeepers” more effective may be our best hope for achieving this.

What explains the collective failure of the gatekeepers – external auditors, analysts, and credit rating agencies – to detect and expose the questionable financial and accounting decisions that led to the collapse of Enron, WorldCom, and other “misreportings” or accounting frauds? According to one view gatekeepers can be expected to perform their monitoring roles diligently and honestly because their business success should depend on their credibility and reputation with the ultimate users of their information – investors and creditors. Lacking this credibility, why would firms even employ auditors and credit rating agencies? Further, if gatekeepers provide fraudulent or reckless opinions, they are subject to private damage suits by those damaged by relying on their misleading opinions.

The fallacy of this view, of course, is that 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. Auditors are hired and paid by the firms they audit; credit rating agencies are typically retained and paid by the firms they rate; lawyers are paid by the

firms that retain them; and, as we have recently learned through embarrassing law suits brought against high-profile investment banks, the compensation of security analysts (who work primarily for investment banks) is closely tied to the amount of related investments banking business that their employers (the investment banks) do with the firms that their analysts evaluate.¹⁴ It is not much of an exaggeration, I believe, to say that firms that hire gatekeepers are paying them for favorable evaluations, not unbiased evaluations. Gatekeepers certainly know this, and that if they give unfavorable evaluations they are unlikely to be retained again.

Thus, an alternative view is that most gatekeepers are inherently conflicted, and cannot be expected to act in the interests of investors and shareholders. This conflict is also more serious than may at first appear because in many cases, such as auditing firms, clients of the auditing firm are typically associated with a single partner of the auditing firm, so that the loss of a client can mean a devastating loss in income and reputation to that partner, and may adversely effect his or her position at the firm. Further, it can be argued that gatekeeper conflict of interest has gotten worse during the 1990s because of the increased cross-selling of consulting services by auditors and credit rating agencies, and by the cross-selling of investment banking services.¹⁵ According to one recent survey, large corporations now pay consulting fees to their auditors that are on average more than three times the audit fee they pay.¹⁶ In contrast, in 1990, 80 percent of

¹⁴Citigroup paid \$400 million to settle government charges that it issued fraudulent research reports; and Merrill Lynch & Co. 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.

¹⁵John C. Coffee, Jr., "What Caused Enron? A Capsule Social and Economic History of the 1990's," Working Paper No. 214, Columbia University Law School, January 20, 2003. See also, John C. Coffee, Jr., "Understanding Enron: It's About the Gatekeepers, Stupid," 57 *Bus. Law.* 1403 (2002); and John C. Coffee, Jr., "Corporate Gatekeepers: Their Past, Present, and Future," *Duke L. J.*, no. 7, 2003.

¹⁶Janet Kidd Stewart and Andrew Countryman, "Local Audit Conflicts Add Up: Consulting Deals, Hiring Practices In Question," *Chicago Tribune*, February 24, 2002, p. C-1;

the clients of the Big Five auditing firms received no consulting services from their auditing firms, and only one percent of those clients paid consulting fees in excess of their auditing fees.¹⁷

Increased cross-selling may reduce market discipline by gatekeepers because it makes it easier for clients to threaten to fire uncooperative gatekeepers. For example, firing an auditor might subject the firm to intense public scrutiny and result in public disclosure of the reasons for the auditor's dismissal or resignation, and may even invite SEC intervention.¹⁸ But it is far easier and less visible for a firm to threaten to reduce its use of the auditor's consulting services in retaliation for an unfavorable opinion. This can be powerful incentive auditors and other gatekeepers to provide compliant opinions. Further, increased cross-selling may make it rationale for gatekeepers to engage in behavior that is very profitable in the short (or intermediate) term but "reputation-depleting" in the long-run.

Finally, an argument can be made that during the 1990's the deterrent effect of legal liability for gatekeepers declined as well, further reducing market discipline.¹⁹ Prior to the 1990's, auditors, for example, faced a real risk of civil liability from class action suits. But during the 1990's Supreme Court decisions together with the Private Securities Litigation Reform Act of 1995 and the Securities Litigation Uniform Standards Act of 1998 significantly reduced the threat of private litigation.²⁰

Thus, to make gatekeepers more effective ways must be found both to reduce their conflicts of interest and to increase the threat of market discipline if they fail to adequately represent the interests of investors and creditors. To accomplish this, there needs to be limits on

¹⁷Panel on Audit Effectiveness, Appointed by Public Oversight Board, REPORT AND RECOMMENDATIONS, Exposure Draft 2000, p. 102. 16J

¹⁸See Item 4 ("Changes in Registrants Certifying Accountant") of Form 8-K.

¹⁹See John C. Coffee, Jr., *op. cite.*, pp. 25-27,

²⁰*Ibid.*, pp. 25-57.

the cross-selling of consulting services by auditing firms and credit rating agencies, mandatory “term limits” for the employment of auditors, the separation of security analysis from core investment banking services, and “noisy exit” provisions for lawyers as in Sarbanes-Oxley. Second, we need to do more to encourage “new entry” into gatekeeper industries and to increase competition among gatekeepers. In particular, the SEC should relax its criteria for “licensing” new credit rating agencies.

Third, we need to revisit the liability system that should be applied to gatekeepers. The current “fault-based” (or negligence) regime has proven to be costly and ineffective. It may be time to consider replacing it with a “strict liability” regime with limits or caps. A strict liability regime would impose strict liability on gatekeepers for material misstatements and omissions in offering documents and financial statements and remove due diligence-based defenses. It would force gatekeepers to take measures to prevent issuer misconduct without requiring a costly inquiry into whether the gatekeepers satisfied inexact standards of conduct (i.e., reasonable care or due diligence defenses). But without limits such a system would obviously be draconian. However, there are a variety of ways to limit the liability of gatekeepers.²¹ An important task for the future is to determine if one of these strict liability regimes is likely to work better than what we now have, which does not appear to work at all.

D. Institutional Shareholders

Another important dimension of market discipline is getting institutional shareholders – pension funds, mutual funds, banks, life insurance companies and endowment funds – to take a more active role in monitoring and disciplining corporate misconduct. As large owners,

²¹For alternative views on this issue, see John C. Coffee, Jr., “Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms,” Columbia Law and Economics Working

institutional investors should have a greater incentive to monitor corporations and should be better able to overcome the information asymmetries and agency costs associated with diffuse stock ownership. Yet, institutional investors failed to protect their investors from managerial misconduct in firms like Enron, Tyco, Global Crossing and WorldCom, even though they held large positions in these firms.

Getting institutional investors to be more effective corporate monitors is undoubtedly a critical part of any hope we may have of empowering shareholders and increasing market discipline. Together, they now hold about 55 percent of the outstanding equity (market value) of all U.S. firms, up from 34 percent in 1980 and just 12 percent in 1960. In the largest 1000 U.S. firms they own more than 61 percent of the outstanding equity. It also seems likely that institutional ownership will continue to grow in the future. With respect to the relative importance of the different institutions, in terms of *assets owned*, their respective shares are private pension funds: 27 percent, investment companies or mutual funds: 23 percent, insurance companies: 15 percent, and public pension funds 14.5 percent. In terms of *assets managed*, however, investment companies are by far the largest: they manage almost 36 percent of total institutional assets, compared to 20 percent for private pension funds, 18 percent for both insurance companies and banks, and 6 percent for public pension funds.

Other than a few public pension funds, however, institutional investors have not played an active role in monitoring corporations. To a large extent, they have been content to do nothing or simply sell the stock of companies where they disagree with management's strategy. One view of this behavior is that it is a rational response to managerial misconduct. Any other course of action would be more costly and less rewarding for the shareholders and beneficiaries

of the institutions. But another view is that institutional fund managers have serious conflicts of interests that incentivize them against direct action to prevent corporate misconduct. In this view, the interests of institutional fund managers are closely aligned with those of corporate managers rather than with shareholders (or owners), which is why they customarily support entrenched corporate managers against dissent shareholders.

What are these conflicts? First, the compensation of most mutual fund managers—typically a flat percentage of assets under management – depends largely on the amount of assets under management. This provides a strong incentive for them to grow the assets of the fund. They are rewarded for increasing the funds under management, and penalized for losing funds that they already have. Further, large mutual funds manage a substantial amount of retirement funds originating with corporations, and this has been their most important source of “stable” funds during the 1990’s. Pension assets now constitute more than 20 percent of total mutual fund assets, up from 5 percent in 1990. Thus, mutual fund managers are unlikely to engage in corporate governance actions that antagonize corporate managers for fear of losing these pension funds.²² Second, corporate culture discourages private pension fund managers from active corporate governance. Corporate managers effectively control their own pension funds, and few of them want to meddle in the affairs of other companies for fear of provoking a similar reaction by the pension funds controlled by those companies.

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 as well as more clout in

Modified Strict Liability Regime,” 79 *Wash. U. L. Q.* 491, 540 (2001).

corporate managerial suites. 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.²³ Also, the Employee Retirement Income Security Act (ERISA) and standard trustee law poses significant legal risks to private pension fund managers who acquire large blocks of stock or are active in corporate governance.²⁴

Thus, making institutional investors more active and more effective corporate monitors cuts at the our cultural and legal foundations and involves complex legal, structural, and philosophic issues, starting with whether we even want to 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? Does not this introduce still another non-transparent principal-agent relationship, fraught with potential conflicts and monitoring problems. And, 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? Of course, if we give up on making institutional investors more

²²While active corporate governance may arguably raise portfolio returns and enhance mutual fund performance, and therefore attract new funds, this relationship is hardly as direct and predictable as the one described above.

²³Requires that at least 50 percent of the value of a fund’s total assets satisfy two criteria: an equity position cannot exceed five percent of the value of a fund’s assets, and the fund cannot hold more than ten percent of the outstanding securities of any company.

²⁴See Mark J. Roe, Strong Managers, Weak Owners: The Political Roots of American Corporate Finance, Princeton, N.J.: Princeton University Press, 1994.

effective shareholders, which shareholders will have the incentive and power to monitor corporate managers? Simply selling the shares of underperforming firms may not be enough.

At minimum, we need to remove the incentives that institutional fund managers now have to support corporate managers. A positive step towards accomplishing this is the new SEC requirement that mutual funds have to disclose annually all their proxy votes during the previous twelve months. This requirement should be extended to all institutional investors. Greater transparency of how fund managers use their proxy votes will at least subject them to scrutiny by their own investors and beneficiaries. We should also review the governance structure of institutional investors themselves.²⁵ In particular, we need to be assured that the directors of mutual funds are competent and represent the interests of mutual fund shareholders, and that they are truly independent of fund management companies. A good start would be to require that a majority of mutual fund boards be comprised of “independent” directors, and to change the definition of “independence” to be the same as that employed by Sarbanes-Oxley and the New York Stock Exchange.

IV. Conclusion

The eruption of corporate accounting scandals and related financial irregularities in the last few years, together with the subsequent revelation of widespread corporate misconduct among American firms, has raised fundamental questions about the effectiveness corporate governance in the United States, and in particular about why there was a collective failure of our various corporate governance mechanisms to prevent or at least alert shareholders and investors to impending problems.

²⁵See the proposal of the International Corporate Governance Network on “principles of shareholder stewardship.”

To some degree, responsibility for recent corporate misconduct must be allocated to the failure of several components of our business and governance system: (1) corporate managers; (2) corporate boards; (3) gatekeepers; and (4) shareholders, and especially institutional investors. In many cases corporate managers failed in their fiduciary duties to shareholders, and were seemingly motivated more by self-aggrandizement and outright greed than by a desire to benefit the corporation and its owners. Corporate boards also failed to represent the interest of shareholders effectively, largely because they either were ignorant of what was going on or did not want to rock the “go along” collegial atmosphere typical of most boardrooms. And where were the “gatekeepers”? Why did the Enron and WorldCom auditors and lawyers not understand what was going on and demand more disclosure and candor, and why did virtually every security analyst fail to see the potential for significant problems in the financial statements (and the associated incomprehensible footnotes) put out by these firms? Finally, shareholders themselves, and especially institutional investors, must bear some of the responsibility for what happened. Rather than actively scrutinizing the behavior of corporate managers and boards, they were largely content to take a passive approach to their investments.

This paper reviews key components of corporate governance in the United States to determine why these mechanisms may have failed, and then discusses steps that have recently been taken to correct these deficiencies as well as some additional steps we might want to take to further improve corporate governance. In specific, the paper reviews recent trends in executive compensation in the United States and the implications for managerial incentives, the effectiveness of corporate boards, the role and effectiveness of “gatekeepers” – auditors, credit rating agencies, security analysts, etc., and the role of institutional investors.

An overriding conclusion of this review, not surprisingly, is that all of our corporate governance mechanisms are beset by serious conflicts of interest, but, not so obvious, is that these conflicts may have become more severe because of changes in our corporate and financial system. As a consequence, it may be time for a comprehensive review of our governance mechanisms to see whether steps can be taken to mitigate these conflicts.