

SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
(202) 755-4846

FOR RELEASE: 1:00 P.M., Wednesday, January 18

CORPORATE ACCOUNTABILITY

An Address by Harold M. Williams, Chairman  
Securities and Exchange Commission

Fifth Annual Securities  
Regulation Institute  
San Diego, California  
January 18, 1978

It is, I think, significant that the opening panel at this year's Institute was devoted to the extent to which the federal securities laws influence internal corporate activities and that all of tomorrow's program will be given over to practical problems of corporate governance. There are, of course, those who regard the former topic as one of the causes of the later species of problems. One thing is, however, becoming clear. Whatever impact existing federal law has on internal corporate affairs, we may well be heading toward a quantum level jump in the degree to which that law controls the exercise of corporate power and authority. As a society, we tend increasingly to look to government -- and that more and more often means to the federal government -- to regulate the performance of conduct traditionally regarded as private in order to insure that it is directed to what is perceived to be the public good. The signs are beginning to multiply that the structure and governance of corporations may not long remain immune from that trend.

I personally do not look forward with any pleasure to the possibility of federal chartering, federal incorporation, or similar measures designed to bring in their wake a body of federal corporation law directed at the structure and governance of the corporation. In my judgment, the emphasis should be on fostering private accountability -- the process by which corporate managers are held responsible for the results of their stewardship -- rather than on devising ways of intervening in the mechanism of corporate governance in an effort to legislate a sort of federal "corporate morality." Indeed, I question whether there can, over time, be such a thing as corporate morality or corporate ethics, as distinct from that of the society of which it is a part, and the people who make up that society. I believe there is only a corporate environment that responds to, and impacts upon, the individual behavior, morality, and ethics of those who inhabit that environment. Government may have a role in creating an environment which facilitates and encourages accountability. It should not, as a general matter, dictate the way in

which managerial decisions are reached or demand that a certain balance be struck between the conflicting groups affected by corporate action.

The implications of the accelerating rush to federal corporate governance legislation are far-reaching. I fear this as the beginning of an effort which will not be successful and, when the effort fails, that failure will, in turn, serve as the predicate for yet more intensive and profound efforts to constrict the latitude of private decision-making. The eventual painful lesson may be that it is one thing for the federal government to legislate on discrete socially impacting issues, such as safety standards; it is another for it to begin to deal directly with the process by which private economic activity is directed and controlled.

I want this afternoon to outline an alternative to federal intervention -- the development of a corporate structure which compels that those who exercise corporate power are held accountable for the consequences of their stewardship. Before turning to that structure, however, I believe we first need to understand the causes of the push for federal corporate governance legislation better than we do. And, as we examine that question, I think we will begin to realize that, legislation -- while it may in some ways be supportive of a more fundamental and broadly based private sector effort -- can not itself be expected to make a significant difference.

Finally, since these remarks are addressed to what is essentially a group of lawyers, it would not do for me to neglect to include a footnote and one which embodies a subtheme which is perhaps my single my most important point. Let me direct your attention to that footnote at the outset: In my judgment and experience, lawyers, as counselors to the corporation and its management, must bear a much larger share of the responsibility for the behavior and public perceptions of the American corporation than they appear to recognize, or at least to articulate. For the legal profession to cloak its contribution to the problem -- and its potential role in its solution -- in its "canon of ethics" and the obligations of confidentiality which that canon imposes, is to be, to some

extent, disingenuous, and at least to become coopted into arguing about the arrangement of the chairs on the deck of the Titanic. If the “canon of ethics” proscribes the lawyer’s responsibility and role in this area -- or in other areas in which the lawyer counsels his client on the client’s relationship and responsibilities to shareholders, potential investors, and the like -- perhaps the canon needs reassessment at least as much as does corporate structure.

### The Parameters of Accountability

In considering the structure and role of the corporation in our society, the first problem is to determine what it is that society expects the corporation to be accountable for. The consequences of any gap between the public’s perceptions of business’s responsibilities and the private sector’s own understanding of its role are bound to be adverse, and a systematic gap almost inevitably means that the private sector responds to its critics in ways which exacerbate the problem.

Unfortunately, the corporate sector has proven disturbingly blind to the trends and changes in public attitudes toward business. We see this in the wave of corrective legislation over the past decade. Early sensitivity to those attitudes, coupled with meaningful action -- including support for legislation when appropriate -- to remedy both real abuses and to correct public misperceptions and misunderstandings, would likely have avoided the clash between business and those who see themselves, quite sincerely, as representatives of the public interest. Once, however, the gap between corporate and public perceptions of business responsibilities becomes entrenched and systematic, non-legislative solutions become difficult and less likely. Ultimately, the occurrence of a massive system failure triggers a legislative reaction which is usually too late and too extreme. I believe we are on such a trajectory on the issue of corporate governance. Indeed, the issue of the very legitimacy of the corporation has itself already come into question and is being actively debated.

What is the proper role and responsibility of the corporation in contemporary society? Clearly, the corporation has both primary economic responsibilities and broader responsibilities which flow from its role in the larger society. Corporate legitimacy was based originally on the fact that the corporation proved itself to be the most effective vehicle for creating the goods and services, jobs, and income by which society improves its standard of living. And, historically, economic and political power have been separated in the United States. Thus, the corporation traditionally was subject solely to the discipline of competition in the market and the motivation of private initiative; those are the organizing principles of the economic function.

The issue of the legitimacy of corporate power -- its magnitude, the uses to which it is put, and of how those in the corporate sector who wield what is perceived as massive power should limit its use -- arises in large measure from instances of abuse. Examples exist and accusations abound of the marketing of products which are known to be unsafe or inadequately tested; of deceptive advertising and packaging; of illegal political contributions; of profiteering which seems to capitalize on the public's plight in times of shortage or distress; and of misuse of corporate position. Public opinion polls reflect very clearly the response to these well-publicized incidents: On the one hand, the public has great confidence in the ability of American business to provide goods and services -- although trust in the quality and safety of those goods and services is declining noticeably -- and still overwhelmingly supports the private enterprise system -- however well what that term means is understood. But it is concern for what is perceived as the enormous power of American business, and the narrow, self-interested way in which it is used, or perceived as used, which draws the adversary line and gives rise to a concern that the power needs to be bridled by government action.

The Committee for Economic Development several years ago defined the role of the corporate manager as "a trustee balancing the interests of many diverse participants and constituents in the enterprise." The Committee went on to enumerate these to

include employers, customers, suppliers, stockholders, government -- practically everyone. The fact of the breadth of the corporation's constituency is almost universally recognized today, but the consequences are seldom perceived. What I believe this expanded constituency necessarily means is that the large corporation has ceased to be private property -- even though theoretically still owned by its shareholders -- and has become, in essence, a quasi-public institution. As a society, we depend on private enterprise to serve as the instrument through which to accomplish a wide variety of goals -- full employment, equal economic opportunity, environmental protection, energy independence, and others. When viewed in light of these social implications, corporations must be seen as, to a degree, more than purely private institutions, and corporate profits as not entirely an end in themselves, but also as one of the resources which corporations require in order to discharge their responsibilities. And, to the extent that business is perceived as failing to discharge those responsibilities, the argument is strengthened, not only for federal corporate governance legislation, but for federal taxation to transfer profits to the common weal.

#### The Lessons of the Accountability Gap

If I am correct that the responsibilities for which we, as a society, hold corporations accountable are becoming broader -- quasi-public in a sense -- and if it is also correct that corporations have been slow to recognize this expansion in their role, what are the consequences? First, if its obligations are becoming in part social, management must be sensitive to the fact that it often continues to respond in purely economic terms. Partially because of uncertainty as to what the broader responsibilities are and how best to address them, corporate management tends to fall back on the assumption that it still derives its legitimacy from the superior efficiency with which it capitalizes upon opportunities in the marketplace. The requisite of a successful response to market opportunities is still present, of course, since a firm which does not meet a need

in the marketplace can hardly serve as a vehicle for accomplishing any other goals, such as providing a source of expanding employment opportunity. But if corporations are unable to move to a recognition of the broader social arena in which they function, there is a real danger that the political process will, over time, subject larger corporations to further integration into the public sector.

Another consequence which flows from a recognition of the broader aspects of corporate stewardship is that management, like other institutions which exercise public responsibility, cannot legitimately be insulated from replacement if it is unsuccessful. If the institution is a quasi-public one, then management does not have the same rights to self-perpetuation it had when corporations were more solely economic animals and management and ownership were close and often synonymous -- before the need for large aggregations of capital led to broad public ownership. Unfortunately, this fact is not widely recognized and even less widely reflected in state corporation law. For example, state tender offer statutes are largely products of state efforts to respond to local interests and protect management from the risks of replacement regardless of the quality of either the purely economic or the broader social aspects of its stewardship. Consider also the message which is conveyed by those state business codes which allow corporations to amend their articles to require, for example, an 80% favorable vote on an unfriendly tender. Where or not that kind of protection was justified in an era when corporations were essentially local enterprises and could more legitimately be seen as exclusively private, it is no longer appropriate today.

The third conclusion which should be drawn from the expanded aspects of corporate management is that, in understanding the implications in terms of the structure of the corporation, we must focus not so much on the question of social responsibility but rather on what might better be called "public accountability," that is, mechanisms which encourage an evaluation of the way in which managers have discharged their

responsibilities, including the quasi-public elements. Responsibility without real accountability does not produce the same results.

### The Mechanisms of Accountability

In considering the state of corporate accountability and the balance of corporate power, it is traditional to begin -- and end -- with the proposition that management is accountable to the board of directors and the board of directors is, in turn, elected by and accountable to, the shareholders. Unfortunately, as we know, those propositions are often more in the nature of myths. The truth is that shareholder elections are almost invariably routine affirmations of management's will and that the historic and traditional shareholder is now a vanishing breed. Most stock today is purchased by people and institutions whose sole intention is to hold for a relatively brief period and to sell at a profit. They do not perceive themselves as owners of the company, but rather as investors -- or speculators -- in its income stream and the stock market assessment of its securities. Perhaps one of the starkest illustrations of this fact is that securities analysts, even for major institutions, rarely involve themselves with corporate governance issues; in fact, they typically do not even make recommendations on proxy voting of securities purchased on their recommendation.

Despite efforts, such as the Commission's current inquiry, to enhance the quality of shareholder information and to revitalize shareholder democracy, I believe it is unrealistic to expect that the shareholder constituency will of itself prove an effective vehicle to keep corporate power accountable. Because of the nature of the majority of these shareholders, they are fully protected if adequate information is made available, if fraud and over-reaching are prevented in securities trading, and if a fair and orderly securities market is maintained. To some extent, the decline in ownership of equities may indicate that even this function is not being well discharged. It is vital that individuals and institutions be willing to invest in a system they trust and in which they

perceive they have a reasonably inviting opportunity for gain. However, many companies do not seem to appreciate that their cavalier treatment of shareholders is alienating them from what should be one of their strongest natural constituencies against government intervention.

The second traditional assumption regarding corporate accountability is also open to question. Many boards of directors, although by no means all, cannot truly be said to exercise the accountability function. The board itself is a mini-society, with all the forces of cooption and cooperation, desire for compatibility, and distaste for divisiveness, which characterize any group. Moreover, the board environment is not particularly conducive to nurturing challenge when the majority of directors are beholden -- as employees, suppliers of goods or services, or due to other conflicting roles -- to the chairman and chief executive. Even friendship itself often inhibits vigorous directorship, although a strong independent director, asking hard questions, in my judgment, performs an act of true friendship. Dissenting directors are, however, rare, and for some reason, they often seem to have short tenure. Thus, the board, in effect, often insulates management rather than holding it accountable.

#### Creating a New Environment of Accountability

With this perspective on corporate accountability and the existing mechanisms of corporate governance in mind, I will turn to the core question -- whether we can improve the existing process and make it work better, or whether we should take steps to modify or replace it.

Let me dispose of the second set of alternatives first. I have not heard any proposals for structural change which I am prepared to accept today. And, perhaps because I die hard, I believe the existing system can be made substantially more effective. I believe we are dealing with a delicate mechanism -- one which can and should function more effectively. Yet I am concerned with suggestions for what appear to be simple

solutions -- suggestions which are too often lacking in full appreciation for the consequences, including the unpredicted consequences. We need to understand what gets splashed on when we make waves. I believe that the superior economic achievement of our private enterprise system and our unequalled political and personal freedom are three closely intertwined and mutually reinforcing characteristics of our society. We need to be cautious in tampering with their balance. Direct intervention, through corporate governance legislation, into how business is run may, over time, seriously disturb that balance.

If, on the other hand, corporations are to preserve the power to control their own destiny, the larger corporations need to be able to assure the public that they are capable of self-discipline and that they will appropriately contain and channel their economic power -- both real and perceived -- in a fashion which is consistent with both the discipline of the marketplace and the noneconomic aspects of the public interest. Mechanisms which provide that assurance must become effective structural components of the process of governance and accountability of the American corporation. The major part of the responsibility for the effectiveness of those structures, and for assuring the public of the corporation's responsibility and accountability, rests with the leaders of the corporate sector and with the lawyers who counsel them.

The first requirement, if government involvement in the mechanisms of corporate decisionmaking is to be obviated, is that those in business understand and recognize the gap which much of the public perceives. Hopefully, discussions such as this Institute will help. The Commission's own hearings on shareholder participation in corporate governance and shareholder rights can also make an important contribution to this educative process -- not solely through any rule proposals that may evolve, but also, and perhaps primarily, by focusing attention on the issue of corporate accountability. Heightened awareness of the problems and obstacles to effective accountability can stimulate self-help in reaching solutions. I believe that the very existence of the

proceedings, the amount of attention focused on the issues, and the number of people who appeared and covered the hearings contributes to that function. Similarly, shareholder proposals and shareholder litigation will also have a constructive effect in stimulating companies to recognize the problem of accountability.

Second, effective accountability depends on identifying certain tension-producing forces and putting them to work in the corporate environment. We need to support the creation and institutionalization of pressures which operate to balance the natural forces that otherwise exist. For example, management quite naturally is the source of pressure for a totally compatible, comfortable, and supportive board. We need to create a countervailing force that works against that tendency towards comfort. Certainly, the relationship between management and the board should not, by any means, be antagonistic, but tension is essential.

In concrete terms, how can this environment be created? The ideal board, in my opinion, would be constructed as follows: First, since the board guards two thresholds - that between ownership and management and that separating the corporation from the larger society -- it must be recognized that there are some people who do not belong on boards -- members of management, outside counsel, investment bankers, commercial bankers, and others who might realistically be thought of as suppliers hired by management. Some of these, as individuals, can and do make excellent directors. Yet all must be excluded unless a mechanism can be designed whereby they can establish their ability to function on a basis independent of their management-related role.

Second, ideally, management should not be represented on the board by other than the chief executive. Such a board environment would not preclude other members of management, counsel, and bankers from being present to contribute their expertise to the deliberations in an uncontentious context. Yet, when it comes to the discussion and vote, the independent director would not be faced with, and discouraged or worn down over time by, what is so often a stacked majority against him.

Third, I believe that the chief executive should not be the chairman of the board. Control of the agenda process is a powerful tool, and the issues presented at board meetings should be determined by a chairman who is not a member of management. The substance and process of board deliberations, and the priority which the board assigns to the matters before it, should not be management's prerogatives. And this also means that hard decisions concerning what the board will take up when time is short and the issues are many should not be dictated by management. Finally, the intimidating power of the chair, when occupied by a chief executive in situations where the majority of the board are indebted to him for their directorship, is avoided.

The type of board I have described is an ideal. I recognize that many companies cannot immediately adopt it in all its aspects, but at the same time, there are few public corporations which cannot utilize some of these concepts. For example, it should be apparent by now that I favor a board of independent directors. In this context, committees of independent directors remain important, but primarily as a vehicle for organizing and dividing up the work of the board. Given a lesser number of independent directors, then committees composed exclusively of independent directors for audit, nomination of directors, executive compensation, public policy, and conflict of interest, become essential. But even this will not be adequate unless the board, as structured, understands and accepts its responsibility and concerns itself with the corporate environment and its compatibility with the essential corporate responsibilities.

The key point is to create a type of board which builds into the corporate structure and turns to advantage some natural elements of human behavior. My suggestions make it less likely that the board members will succumb to the very human tendency to simply follow along with management's recommendations, management's agenda, and management's attitudes. This is not inconsistent with the true role and responsibilities of the chief executive, and nothing substitutes for a relationship of mutual trust between the chief executive and the board. By suggesting the institutionalization of certain

countervailing tensions, I am not proposing anything contrary to, or destructive of, that mutual trust. Indeed, my most important rule for board membership is trust in the chief executive. If that is lacking, the directors should either replace him or get off the board.

Aside from changes in board structure, I believe that the concept of corporate accountability requires that new mechanisms must be created to judge management based on the full range of its responsibilities; that is, its responsibility to both ownership and society to balance short-term and long-term profitability, taking into full account the political and social expectations of the firm, specifically and as part of the larger corporate community. Holding management accountable can enhance economic performance -- let alone other aspects. For purposes of this discussion, I will concentrate on the latter.

The quality of an organization's performance is vitally affected by its systems of measurements and control -- the lenses through which it views and evaluates itself. The typical manager functions with a high level of confidence that, if he meets his short term economic targets, he will be rewarded -- and certainly not criticized, let alone severely punished, for failure to perform adequately in other areas. Unfortunately, however, much of what we characterize today as sophisticated management control encourages and rewards conduct often contrary to the long-term best interests of socially accountable business.

Corporate control systems need to assure that what is being measured and what is being rewarded conform to what is expected of business. The longer term and the social and political impacts of current decisions must be both visible and consciously accepted. Reward systems need to make those concerns worthwhile. I am not advocating elimination of incentive compensation or options; I fully support them. I am urging that we understand the behavior that these systems encourage and reinforce, and that we design them to include appropriate countervailing pressures, rewards, and penalties. Absent measurement and control systems which recognize explicitly the long-term and

non-economic aspects of managerial responsibility, executives on the firing line, charged with implementation, may not believe that the board and the chief executive mean what they say when they promulgate codes of ethics or talk about high standards of corporate conduct or that they are doing anything more than making a public relations statement for the record and external consumption. When it comes to conduct which makes a manager's life more complicated, or does not seem to be consistent with profits, many managers are inclined to ignore or disbelieve, to delay action and to implement with little enthusiasm, unless there is some tangible evidence that that conduct will form a real part of the evaluation of that manager's performance. This is not a condemnation of corporate ethics -- it is a recognition of human behavior. In order to be effective, the mechanisms of corporate accountability must also incorporate that recognition.

### Conclusion

A well-known legal historian and scholar, Professor Willard Hurst, has observed: “[W]e feel very strongly that there should be in the society no significant center of power, which is not somehow accountable to external checks outside of the immediate power holders \* \* \*. [F]rom the 18th century on, the idea was that we would check and legitimize entrepreneurial will by holding it accountable to owners. But if the owners cease to be interested as managing owners, if they become interested simply as participants in flows of income, then where does one find the basis for legitimizing the entrepreneurial will which the society so highly prizes?”

I have tried to set forth this afternoon some of the reasons why I believe that, in part at least, the answer to that question lies in creating an environment in which managers are subject to meaningful scrutiny, by an independent board of directors, of the manner in which they discharge their stewardship responsibilities. Our goal should be to create processes which encourage that scrutiny, not to draw lines which confine or

restrain it. Holding corporate management accountable in more effective ways will also have collateral benefits -- such as strengthened management and improved allocations of scarce resources and profitability. But we can't expect management to lead the way alone -- because it would make life less comfortable and secure for it and is contrary to its short-term, day-to-day interests.

Government has a role to play in this process. That role is, however, in many ways very limited. Government -- and I expressly include the Securities and Exchange Commission -- does not have the requisite wisdom to be prescriptive, and, as I have indicated, the area does not, in any event, lend itself to solution by prescription. Instead, the Commission's role -- and the role of government generally -- is to help create an environment which encourages corporate accountability and to stimulate the private sector to take advantage of the opportunity which that environment affords to earn and maintain public trust.

We must begin that process with a recognition and operational redefinition of the responsibility of the corporation in this society, the resulting role of the board, and the new corporate environment that needs to emerge. This will take time, understanding, and continuous pressure on the status quo. Reality will always lag what is desirable and progress will be too slow. Indeed, it is slower than we can afford. We can not be intimidated by "if it ain't broke, don't fix it;" by the discomfort of bucking the management club; or by the enormous problems of implementation -- problems which no one can exaggerate better than lawyers.

That observation permits me to close by returning to the point which, at the outset, I labelled as my subtheme: The corporate lawyer, in his role as director, counsel, and draftsman of articles, by-laws, incentive compensation plans, and in myriad other ways, has a crucial choice. He can be the mechanic -- a highly skilled but essentially non-professional technician -- and thus a perpetuator of the problem. Or he can choose to bring to bear his broader vision and his sense of responsibility to both the corporation and

the board. Corporate leaders, and those who advise them, including many in this room, must realize that each issue cannot be treated as a discreet, narrow case, but rather must be seen as a part of a much larger pattern in the mosaic reflecting the relative roles of the public, government, and business -- and of board and management -- in our private enterprise system. We are now mounting pieces of that mosaic. If the corporate community, including its counsel, does not like the picture at the end, it should begin by blaming itself.