

REMARKS

BY

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U.S. SECURITIES AND EXCHANGE COMMISSION

“CORPORATE GOVERNANCE:

INTEGRITY IN THE INFORMATION AGE”

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Thank you for your warm welcome. I'm very pleased to join you here in New Orleans, for the 10th annual Corporate Law Institute at Tulane. For the past decade, this conference has brought together some of the finest minds in corporate law. Your discussions make a real difference in the way legal professionals advise America's companies.

Just think of how far our nation has come since 1988, when you began convening this institute. In 1988, our markets were struggling to recover from the sudden break of the previous October. Now, our markets are setting all-time records. In 1988, pundits were warning that America's consumer-driven marketplace was no match for Asia's government-guided economies. Now, the American market is recognized as the most resilient in the world -- while Asia suffers from the flaws of its "crony capitalism."

In 1988, skeptics were claiming that America would never get its economic house in order. Now -- as we achieve a balanced federal budget -- we have created the basis for a strong, sustainable expansion. It's a record we can all be proud of. Our nation's success is driven by the creativity of our corporations and our markets. As we confront the intense demands of the Information Age, American business continues to show great leadership in an area that is crucial to the integrity of our marketplace: responsive corporate governance.

Thanks to the swift flow of reliable information, corporate decision-making has become more accountable to the true owners of every company: the shareholders. Over the last two decades, our companies have become more open. Boards are now armed with the information they need to make key decisions and to monitor the performance of corporate managers. Shareholders are now better able to hold corporate directors and officers accountable for their actions.

At the Commission, we have carefully tracked these trends. Yet corporate governance has not generally been a subject at the top of my agenda. During my almost-five years at the Commission, I have only rarely addressed this issue. But don't mistake my soft-spokenness for a lack of interest. In fact, before I came to the Commission, I spent a large part of my career on and around corporate boards.

I was reluctant to discuss this issue at great length for a simple reason: I was not fully persuaded that the Commission had any relevant administrative expertise to contribute. Much of the corporate-governance debate today focuses on questions of form and abstract principle. But I have always strongly felt that these issues would not be solved by a "one size fits all" solution.

I tend to agree with a point made in the Business Roundtable's recent Statement on Corporate Governance. "The substance of good corporate governance is more important than its form," the Roundtable said. "Adoption of a set of rules . . . is not a substitute for -- and does not itself assure -- good corporate governance." In leaving this

debate mostly to others, however, I always strongly agreed with a basic principle -- that a board acts as a fiduciary on behalf of a company's shareholders.

In the words of Justice Horsey of the Delaware Supreme Court, in the seminal Van Gorkom case:

A director's . . . fulfillment of the fiduciary function requires more than the mere absence of bad faith or fraud. Representation of the financial interests of others imposes on a director an affirmative duty to protect those interests and to proceed with a critical eye.

Some of the most significant contributions to this area of the law were made by participants in this conference -- Justice Moore (who, I note, was in the majority in the Van Gorkom decision); Chancellors Allen and Chandler; and Vice Chancellor Jacobs. As members of the Delaware judiciary, they established -- through the persuasiveness of their arguments -- that directors are the representatives of shareholders.

Lately, I have become increasingly convinced that the Commission can be, and should be, more outspoken in this area. This is especially important in discussing the link between a company's directors and its corporate reporting and information systems. And I have been struck by another factor, too. There has been a great deal of surprise, within the corporate community, over several recent judicial opinions and administrative actions at the S.E.C.

I had thought that these decisions were just common sense. So I may need to clarify where I stand, and why. My remarks this afternoon are focused on one aspect of corporate governance: the crucial role of boards of directors as representatives of the shareholders -- and for the shareholders' rights to full and fair disclosure. To be effective advocates, boards must assure themselves that directors have full access to the information they need in order to oversee the conduct of business.

And, when necessary, boards must assert their responsibility to take swift and decisive action. In this information-driven age, the director's responsibilities have become more complex. But the director's role rests on an old-fashioned value: integrity. Integrity of character. Integrity of information. Integrity of auditing and compliance systems. And, above all, integrity of mission.

The director has a legal duty and a moral mandate: The director is the shareholder's representative. In recent years, we have seen too many examples of companies whose boards could have -- and should have -- been doing better jobs. There are too many boards that overlook more than they oversee. Too many that substitute CEO directives for independent initiative. Too many that are re-active instead of pro-active.

Such boards do a disservice to their companies -- and they do a disservice to shareholders. Chancellor Allen's recent opinion in the Caremark case helps illuminate the

broader issues in this debate. Some of Caremark's executives illegally paid Medicare and Medicaid patient-referral fees to other health-care providers. In settling various criminal charges and lawsuits, the company paid about \$250 million in reimbursements and penalties. Some of the company's shareholders sued, claiming that Caremark's board failed to oversee management.

In his opinion, Chancellor Allen -- in the context of approving a settlement -- suggested that the Caremark board of directors would have been free from any liability. That was because they had exercised an appropriate level of oversight. He wrote: "I am of the view that a director's obligation includes an attempt -- in good faith -- to assure that a corporate information and reporting system, which the board concludes is adequate, exists."

Chancellor Allen's reasoning was based on a fact that seems quite clear: Relevant and timely information is an essential element in satisfying a board's supervisory and monitoring function. From the hue and cry that followed, you might have thought that the ground had shifted beneath the feet of Corporate America. Mountains of law-review articles were dutifully written. Lawyers dispatched urgent letters, warning board members of this latest exposure to liability.

Was I surprised by this reaction? Quite frankly: Yes. I had thought that, by now, we all recognized the trend. We're all aware of corporations that have fallen on hard times, or at least found themselves in serious legal difficulties. We're all aware of cases in which one can fairly ask: Where was the board? What kind of tone did they set at the top? Were they an active, thoughtful group that exercised prudent oversight? Or were they a passive, rubber-stamp of a board -- with directors who never pursued a tough question and never rejected an easy answer?

When a corporation finds itself in trouble, it often becomes clear that the board didn't fully discharge its responsibilities. What is obvious in hindsight, can be avoided through foresight. In practice, this simply means that boards must be equipped with an effective system to monitor management. But directors can't stop there. If they have reason to know something doesn't seem right -- or if the red flags are flying -- they cannot avert their gaze.

A case brought by the Commission late last year illustrates my point. In that case -- concerning W.R. Grace -- some of the officers and directors failed to fulfill their responsibilities to investors under the securities laws. On two points, they did not satisfy their duty of disclosure. The former Chairman and CEO of W.R. Grace had negotiated a retirement package that included some generous perquisites -- including the use of a corporate jet and a company-owned apartment. The perks were valued, at one time, at \$3.6 million. W.R. Grace was also negotiating to sell a small subsidiary to the ex-Chairman's son.

It's not as if the directors were in the dark. One member of the board of directors led the negotiations for the perks. Another was aware of the negotiations for the sale. From an S.E.C. perspective, the problem was not with the substance of the transactions. The problem was: No one told the shareholders much about them. They were not fully disclosed or described, as the law required. The company's SEC filings contained only the briefest and most obscure description of the perks: Moreover, the Company didn't even bother to disclose the proposed sale to the ex-Chairman's son.

In deciding this case, the Commission determined that not only the company, but several of W.R. Grace's directors, bore responsibility for these failures. Each of those directors knew about the perks or the proposed sale. Each of them should have known that such sensitive matters would raise a red flag for shareholders. Each of them was familiar with the process by which Grace's lawyers gathered information. Each of them had reason to know that the lawyers were not fully informed on these matters. And each of them could have brought these matters to the attention of the lawyers preparing the disclosure. Each of them could have asked why those matters had not been fully disclosed.

In the aftermath of our decision, I was again surprised by the strength of the reaction. Many lawyers -- including one of my colleagues, Commissioner Wallman -- interpreted the SEC's action to imply an extension of the board's responsibilities in overseeing a company's disclosure system. Many also interpreted the action to imply that directors could not rely on their lawyers' counsel. Simply put, those arguments are incorrect.

Neither my colleagues nor I would ever suggest that directors cannot reasonably rely on a corporation's internal processes for preparing disclosure in the ordinary course of business. We also do not intend to suggest that directors cannot reasonably rely on the corporation's lawyers to advise them on what must be disclosed. But if this case does assert a principle, it is this: When corporate directors have reason to know -- because of their positions and expertise -- that important information is not being disclosed, it is their responsibility to ask the basic question: "Why not?"

Moreover, a director cannot rely on counsel's advice if he or she has reason to know that the counsel is not fully informed. For financial reporting issues, another group of directors should be asking hard questions, too -- namely, the audit committee. These committees, in their special role, must help the board fulfill its oversight responsibilities in such areas as financial reporting and internal controls. They also are the primary link between the directors and a company's outside auditors.

Many of you know that I feel very strongly about the special role and responsibilities of independent auditors. They are -- as the Supreme Court once said -- "public watchdogs" over Corporate America. Yet even these watchdogs need help in performing their vital role, and that responsibility belongs to the audit committee. Those

position to monitor new developments -- and to address problems earlier, rather than after serious injury to the corporation has occurred.

I've given you my views on the importance for directors to stay informed, stay involved, and stay on the alert. Now let me offer you some final ideas, to take with you when you've left this conference. Every time directors sit down at the boardroom table, thousands of shareholders sit down alongside them. So we must have a system that gives directors timely information, to help them represent those shareholders.

Every time directors ask a tough disclosure or financial question, thousands of shareholders will benefit. So we must have an atmosphere that encourages directors to be active -- to avoid the trap of believing that they must "go along to get along." Every time directors stand up for what's right -- even if they think they might be alone -- thousands of shareholders stand with them. Directors must remember: Protecting the interests of shareholders is the goal of corporate governance.

The task of upholding the integrity of our entire corporate system begins with the work of directors. When our system lives up to the highest standard of integrity, it inspires deeper public faith that our marketplace is sound. Maintaining the integrity of our system is the director's legal mandate -- and it must become a fundamental part of every director's mission. Thank you very much.