Lecture Text

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Corporate Governance in the U.S.:
Scandals, Reforms, and the Future

(*edited for clarity*)

Introduction

Good afternoon. The topic of corporate governance is clearly a hot topic around the university and around the country and in fact around the world. It is a topic of great debate. I was just this morning at a seminar at the Law School with whom we now have, I think for the first time in the 300-some-odd-year history of this university, a joint seminar with our colleagues over there. And the topic this morning was a symposium the Law School was sponsoring about the SEC's new proposal to give shareholders more direct access to the proxy statement for the election of directors, which may turn out to be a bunch of nonsense. But nevertheless, I know they're going to make a formal proposal next Wednesday for comments. I mean, that's just one example of the issues that are churning around out there.

And we've been very active at the school over the last year really trying to get a deeper understanding, and we continue to try to get a deeper understanding of the topic: What went wrong in the United States, and what kind of reforms are there and what should we be thinking about for the future?

But I want to start with a comment that Kim Clark made at a talk he gave at the National Press Club. It was last winter, perhaps last February, in which he started out by saying that the problem was not just a few bad apples, but that the problem was that there were some flaws with the barrel itself. And I want to talk with you mostly about the barrel because I absolutely agree with Kim's analysis of the situation and so let me without further ado jump into this.

The U.S. Corporate Governance System

Let me talk first of all about what we mean by the corporate governance system, or at least what I mean, but I think my colleagues generally share this description of what it is we're worrying about and what it is we're talking about.

The company, board, management, and shareholders

Obviously at the center of the system is the company, and close in the governance mechanism is the board of directors and the relationship between the board, the management, and the shareholders. And I'll come back and talk about that shortly.
But also recognize that there are a whole lot of other institutions that are part of the corporate governance system and that affect and control all kinds of companies.

The SEC

I can start in the middle with the SEC since we were listening to one of the commissioners last night at this workshop at the Law School. And we all know what they do: They're basically the federal government's arm for regulating securities transactions and so on, and all those things connected to it, and they control the proxy process. And therefore, they're finding their way into saying some important things about boards and about corporate governance more broadly.

Courts
Just to keep going in this direction, we also obviously have the courts. In the United States under our common law system, the courts make decisions that basically become law. And the most important court in the land is not the federal court but the state courts, and most importantly the Court of Chancery in the State of Delaware, where over 50 percent of U.S. corporations are in fact incorporated. At the conference this morning we had Leo Strine, who is one of the chancellors. But they do make pronouncements and settle cases and when they settle cases, they are basically setting case law, which establishes what directors need to think about and worry about and what they're supposed to do.

Security analysts and the stock market
We have security analysts, who have gotten a lot of attention; I'll come back to them. We have the market itself, most importantly the New York Stock Exchange and the NASDAQ, and we've all seen commotion at the New York Stock Exchange over the last few weeks. I just was reminded of my old buddy John Reed back in the middle of that and I'm sure he will do a great job of straightening it out. But nevertheless, it reminds us that that's part of this governance system.

Institutional investors
We also have the institutional investors and their organizations and I think what's important to understand in the context of the United States is that the most active and vocal institutional investors really don't hold much equity. They are the so-called public pension funds: CalPERS; the New York State Employees Pension Fund. They own something like less than 10 percent of the total equity, but they make about 90 percent of the total noise. And, for example, at the seminar this morning we had Sarah Teslik, who is the CEO of the Council of Institutional Investors, which represents those people, and we had Damon Silvers, who's actually a graduate of this school and the Harvard Law School and who is the Associate General Counsel of the AFL-CIO, big pension funds. So these people are out there and they are making noise and they are impacting politically on the process.

Auditors and law firms
Obviously we talk about the auditors and the law firms who are also part of this system, and I'll come back in just a moment to talk about all that. But that's the system that went wrong in some important ways and that's what I want to start by talking about.

Keys to Effective Corporate Governance
But let's remember that there are really two keys to effective corporate governance. One is that the system somehow has the power to oversee management in a broad sense, because that's really the responsibility of corporate governance systems: to oversee management. And you notice that I haven't said on behalf of anybody because it's more complicated than that. Most of you will say, "What about shareholders?" Well, that's a big debate. Is the governance system existing just for the shareholders, or not? Or more? And the argument turns out to be that it depends on who you talk to. But clearly the idea of oversight is one key element in an effective system. And the other is that we provide transparent and accurate information for investors. And if you think about it, whenever we've had problems, one of those two things has gone wrong. And so I want you to just keep that in mind as I talk here.

Sources of Power
Now what's the source of power for those various actors to get something done? Well, clearly some of it rests in laws and regulations; that's pretty obvious. Secondly, particularly

when you get into the boardroom, it has to do with the norms of the board itself and my argument is on the cohesion of the directors. The board's real power does not rest in the laws, in my opinion. It really rests in the determination of some number of men and women who are on that board to stick together and say to the CEO, "You may not do that," or "You should be thinking about this." If you get into that situation, my argument would be even the most intransigent CEO is going to find it very, very difficult to resist the power of that kind of a board. So I think social norms and cohesion are important.

Obviously there's economic power. You know, the shareholders who buy and sell stock, the ones I didn't mention. The big institutional investors, the Fidelitys of the world, the hedge funds and so forth, they use economic power to get management to do what they want it to do or what they think it should do.

And finally, there's the whole notion that the system, that the institutions within the system, have to have legitimacy. And I think part of the issues we now are facing are that some of these important institutions have lost their legitimacy, or at least their legitimacy is being questioned.

What Went Wrong in 2001?

Now, what went wrong in 2001? You know, it all started that fall day when Enron went into the tank. And I would say there were problems—I mean, there are many other problems, but there are four pieces of the system that I want to talk about. One is what happened with the analysts and the bankers? Second, what happened with the auditors? And then I want to talk a little bit about what happened with CEOs and other senior executives. And finally, I want to talk about the board. Because I think those are four pieces of the system that we found to be flawed in one way or the other.

Analysts and bankers

Let me start with the analysts and the bankers. Have I got any investment bankers here in the room? Well I'm going to make you all mad. No, I don't want to, but I think it's pretty obvious that we had created what were called Chinese walls to separate the bankers from the analysts and the traders and so forth, and somehow we found a little bit of holes, some holes in those walls. And that really created an opportunity for Mr. Spitzer and others to be critical of what was going on.

I think the other thing that is really critical to understand is what really were the analysts' incentives in this game? And not just the analysts' incentives but also the money managers' incentives? This really goes beyond the banks. But the problem is that a lot of the incentives in the financial system are to produce short-term results, to increase the value of the portfolios. That means you've got to get the stock prices up. What the analysts prefer and the money managers prefer is the steady, quarter-by-quarter growth in earnings. And there are immense pressures in the system that cause that to happen. And as I said, we had three or four workshops in the last year to which we invited some of our alumni and some distinguished business leaders who were not alumni. John Reed happens to be one of those. But I remember at one of these meetings that both John and Bill George, who was the Chairman and CEO of Medtronic, were sitting in the room. And they both said exactly the same thing within about thirty seconds of each other, and it took me a minute to catch the implication of what they really were saying. They said that the analysts are really the ones that set corporate strategy. The analysts are the ones that really set corporate strategy in large public companies. And I think it's worth thinking about. Basically what they're saying is that there's so much pressure coming from the analysts for short-term earnings that that sets the financial goals and targets of too many companies. And as a consequence of that, we have this immense focus on short-term earnings. So that's one of the pieces of the system that a lot of us here think we need to think about how to mend and how to fix. Not to do away with analysts, although maybe some of that has happened already, but how to make the system work in a way that can return the focus to long-term earnings.

Auditors
Now the auditors. As we all know, probably the most publicized piece of the whole debacle, next to Enron, was the fall of Arthur Andersen. You know what happened there? Well, this is a very quick version of a much more complicated story, which really starts with the Federal Trade Commission trying to encourage auditors to compete with each other. Once that started, we found that audits became a commodity and the best way to make money in a commodity business is to reduce the price. If you reduce the price, you have to figure out ways to do the audit cheaper. Also at the same time, these audit firms, because they weren't making as much money on the audit side, began to get excited about consulting and tax practices. There were opportunities there; it fed that part of their profession. And what happened as a consequence of those two things was the erosion of really the audit practices. There were the lower margins; the quality of the staff of most of the Big 8—what is now the Big 5—accounting firms declined, and you can see evidence to that effect if you talk to anybody who is in those firms; audits were computerized; and the quality of audits finally fell. And I think what happened in the audit profession was that it became a huge, giant conflict between the partners' desire to make money on the one hand and their professional obligations to provide accurate and transparent information to investors and to others.

So the audit profession has had its problems and it still has and I think it is still trying to figure out how to resolve this. Because it really isn't easy and it's complicated by the fact that some of the money-making ends of their business are really being taken away from them or reduced in scope.

Executives
Finally, I think we had the loss of executive integrity. It happened with CEOs; it happened with CFOs and probably a lot of other managers. Somewhere in the '90s, America got very aware of the opportunity to make money. Everybody was getting rich, right? The twenty-two-year-old entrepreneur in Silicon Valley was starting his dot-com company and he wasn't having any profits, may not have even had any revenues, but he was making huge amounts of money. Investment bankers were making large amounts of money. Accountants were making large amounts of money. Lawyers were making large amounts of money. And of course the CEOs were making large amounts of money, and when the CEOs make large amounts of money, everybody in the company does. No, they don't make quite as much money but they get a lot of money. So everybody was getting rich and everybody was trying to figure out how to game the system so they could continue to get rich. And this led to a lot of these accounting tricks. Not necessarily fraud, but reserves, restructurings, different ways of recognizing revenue and timing revenue and all that stuff. And all of that led to people doing things, starting things that weren't quite illegal. But you know, once you start doing things that are wrong, you start down this slippery, muddy slide and all of a sudden you find some extreme examples of people involved in fraud and we've seen that a number of times. We all know where that was.

The other thing I think that worries me was that the role of the chief financial officer changed in a lot of companies. Whereas the chief financial officer used to be a check and balance on the CEO about financial prudence, care, all that stuff, suddenly the CFO—and you can see this very clearly at Enron—became a profit center. His objective was to make money through financial tricks and manipulation and new kinds of products and all of that. So we lost one of the real elements of safety in the system.

And of course out of all of this, we still have these problems of executive compensation; witness the difficulties of the stock exchange with Mr. Grasso. But apparently it was Mr. Grasso's excessive compensation. So all of that is pretty well described, I think, in this diagram. And this is my representation of what went on, but if you want to get a better and more articulate view of it, I can recommend to you an article written a year ago this summer in *The New Yorker*, of all places, by John Cassidy who is the economics writer, I think, for *The New Yorker*. I didn't know *The New Yorker* had an economics writer, but they got Cassidy and I think he has it just about right. And you can break into my little cycle anywhere you want, but let's just start with the incentive for CEOs, which was basically in options and stock. So now we got to get the stock price up so the options are in the money and whatever restrictive stock they're getting is worth more.

So what do they do? They go to the auditors and they say, "Please, auditors, let us play a few little tricks here and we'll look better." And the auditors, wanting to keep their clients, sort of wink and say, "Yes, that's okay." And part of that comes from the institutional investors who are focused on short-term earnings growth. They like these accounting tricks because it gives them the kinds of earnings they want to drive the share price up. Share price goes up and the CEOs get more money and the whole thing works beautifully, right? Except it kind of kept going in a crazy circle. And in the middle of all that is this board of directors, which is supposed to be keeping control of the system. And the directors, I have to tell you, were just as confused as everybody else. In some instances, they got just as caught up in these tricks and pressures for more compensation as anybody else. And so that cycle of greed I think persisted in America for a while and then led to a certain number of reform initiatives, which you probably all know about: Sarbanes-Oxley; the listing requirements of both the New York Stock Exchange and NASDAQ, still in the hands of the SEC, but eventually the SEC is going to reconcile the two sets of recommendations and I suspect come back with some rules.

I think we've also seen obviously that both the Justice Department and the SEC are more aggressively enforcing the existing laws and regulations. Now we have a new proposal from the SEC that somehow shareholders should be able to nominate under certain conditions a short slate of directors for the boards of certain companies. Exactly what that proposal is going to look like I can't tell you. But it's going to be out here within the next week. So all of those are initiatives, and there may be others that I haven't mentioned, but there's a lot going on coming from outside the system.

Boards
Now I want to turn to the boards, because in essence they are, in my view, at the heart of any corporate governance system. I don't know any place in the world where we don't have boards. They are required by the laws of almost every country in the world, and as far as I can see, there's no obvious alternative to boards. I mean, you can say that they are a terrible institution, that the idea of expecting ten men and women who are basically part-timers to oversee companies worth billions and billions of dollars is absolutely ludicrous. You can make that argument. Fact of the matter is, I can't think of a better way to get at it, and I don't think anybody else has been able to do so either.

But what I think is also clear is that boards in this country, at any rate, became much more active and empowered during the '90s. In spite of what I just said, I think boards generally were dedicated to trying to do a better job. But I think many of them also failed and we've seen the examples: Tyco, WorldCom. In any one of these companies that failed, there was also a related board failure. And I also believe strongly that it isn't going to get any easier. Boards are going to struggle in the future because we are demanding more of them. All these new laws—Sarbanes-Oxley just is one example—require directors to do much more than they have ever done before. And I think the bar in general is being raised.

I mean, I think there's no other message out of the New York Stock Exchange fuss of the last couple months. Because here was Grasso doing a really good job by everybody's judgment, I think, and suddenly he's in big trouble. Here's this board, which nobody had ever questioned before, very distinguished business leaders, being criticized for what they did or didn't do. Fact of the matter is, what that says to me is the bar has been raised for all of us. Anybody who serves on a corporate board, anybody who's an executive of a major company, has to realize that what's expected of them is today higher than it was two years ago, whatever that means specifically. And so I think those new demands are going to make the board's job harder and I also think that companies obviously are getting bigger and perhaps more importantly are getting more complex. They're operating globally; technologies are changing rapidly. All of that means that the boards have much more complicated entities to try to figure out.

Responsibilities of Boards

Now what are boards supposed to do? I would argue that fundamentally and basically they're supposed to monitor the performance of the company: its strategic direction, its financial accounting and performance, and the CEO's performance, what he or she should be paid and how long he or she should be in the job. Also obviously boards do make decisions. People tend to forget that, but they do make decisions about the tenure of the CEO and who's going to be the CEO, about acquiring other businesses, about divesting businesses and major capital commitments. It varies from company to company. And finally, boards continue to do what they've always done: give advice to the CEO. And different boards do different mixes of that activity and probably should, I would argue. But the fact of the matter is that they do all three of those things.

Key Assumptions about Boards

Now, as boards improved during the '90s, there were certain key assumptions underlying these improvements.

One was that the board had to be more powerful than the chief executive. That is, how could a board oversee, monitor the performance of the chief executive if it didn't in some sense have more power than that CEO? So that's one of the things that has been really going on. And I would submit today that boards truly are more powerful than they were a decade ago. We wrote a book in 1989, which we called *Pawns or Potentates: The Reality of America's Corporate Boards*, and it posed a basic question: Are boards pawns or are they potentates? I didn't even know what those two words meant. My wife's title is a terrific title. But what I would say to you today is that at that time they were too much like pawns and not enough like potentates. Today I would say that they're moving more and more towards the potentate end of the spectrum, which should be good for anybody who's concerned about corporate governance.

Now another big assumption here is the assumption about an independent majority. I'll come back to that. And what the board's role is, I've spoken to that. And finally, there's this notion that somehow directors should be aligned financially with the shareholders, which frankly is one of the arguments that John Cassidy in that article in *The New Yorker* pokes a huge hole in. And I happen to agree with him. I think one of the problems we got into over the '90s was we were all sucked in by the financial economists who somehow told us that this corporate governance problem was an agency problem. That is, that the directors were the agents of the shareholders. Well, the fact of the matter is that I'm not sure what that means, first of all. And secondly, what I'm very clear about is that it isn't just a question of not being a good agent. It's a question of a very complex set of relationships between CEOs and directors, which you just can't define in terms of a concept like alignment. And if you think about financial alignment, just ask yourself: Is it a good idea for a so-called independent director to be a huge shareholder when he or she is being required to look after the interests of all the shareholders? We see this problem in excruciating detail when we look at venture capital boards taking their companies public, the boards of companies financed by venture capital funds taking their companies public, and suddenly the venture capital representatives on the board are in a huge, conflicted situation. They want to get the money out as fast as they can for their investors, but they have responsibilities to a whole lot of new investors who have nothing to do with their funds and they're compromised. So this notion of aligning directors with shareholders is a much more complicated problem or idea than I think has previously been recognized.

Structure and Process Changes
Now with those assumptions, we began to make some real changes in most boardrooms in America. We first of all began to recognize that you needed to have a leader for the independent directors who was not the CEO. I am convinced that we are never going to be able to get American managers in large numbers to do what their British counterparts have done and accept the idea of separating the role of chairman and CEO. But I think this idea of a lead director who is selected by the independent directors and who is not the CEO probably is a good substitute.

I think there is a second point, and this morning I heard John Castellani, who is the president of the Business Roundtable, which is the trade union—is there such a thing?—the trade union of the CEOs of America's largest companies. And he had some statistics, and I don't want to go into all of them in detail. But his point was that a large majority of the boards represented in his organization now have an independent leader. They now have the independent directors meeting alone without the CEO, quite often at every board meeting but at least five times a year, he said. And obviously those things are really important indications of the change in the power of the board and also indications that the board really is serious about doing its job. Because once you get a bunch of directors in a room by themselves without the CEO, it's amazing what they say to each other. Directors are basically polite people. Even if they're going to say nice things about the CEO, they would rather do it with her not in the room. And so we find we get hugely different communication when we get the directors meeting alone without the CEO.

Now there's another big shift here. As you probably all know, there are three committees that are virtually required: the audit committee, the compensation committee, and a corporate governance committee. I think another big change has been that no longer are boards made up of the CEO's best friends or golfing buddies. But now I think we're seeing a systematic attempt in most boardrooms, or more boardrooms, to say we ought to have a board that has a portfolio of different skills and talents, that the corporate governance committee is going to be responsible for finding those directors. It doesn't mean you can't talk to the CEO or the CEO shouldn't have some input, because I can't see how you can have an effective board if the CEO doesn't like the people on the board and feels he can't work with them. But somehow we're putting control of selecting directors back in the hands of the board itself and we're really looking for a portfolio of talents that fits each particular company.

And we also find that within these best practices, the boards are focused on three key activities. One is the strategy of the company. Second is the evaluation, tenure, and compensation of the CEO. And finally, overseeing management succession. Obviously none of that works unless the board is getting the right information. And I think this is still a problem and I'll come back to that in a moment. But finally, boards are more and more making a serious try at assessing their own performance, and I'm talking about the board as a whole here. You may want to talk a little bit about evaluating individual directors, but I think that's a more sensitive and complicated problem. But at least we've got boards that are now in the business of every year or so saying, "We're going to evaluate our performance and see how we're doing and how we could improve ourselves."

Constraints on Board Effectiveness
Now we did all that in the '90s and everybody thought, "Oh, this is terrific. We're making great progress." But somehow something went wrong in at least some boardrooms. And I think part of the problem is that there are some constraints on board effectiveness. And I've listed them and I want to go through them really quickly. There's the problem with independence. There's the fact that boards are basically groups. There's a very complicated relationship between boards and their CEOs. I think there's also a lack of attention in too many boards to what they're trying to do, and I'll come back to that in a moment. And none of the others are really addressed very well by the reforms that have taken place so far. And I think there are still problems.

The downside of independence: time and information
Now the easiest one to deal with is the time and information problem; what I call the low-hanging fruit. If you've got independent directors, what you've essentially got are part-time nincompoops. Think about it. You basically are saying we can't put anybody on this board who knows anything about the company. No suppliers, no customers, no former employees. I mean, the whole idea of independence is that you don't know anything. I'm exaggerating a little bit to make my point. It's also true that these independent directors are part-timers. Everybody understands that. If you ask me what went wrong with Mr. Grasso's compensation, I would say that a number of things went wrong. But one thing for sure was that the compensation committee was made up, among other people, of the CEOs of some of America's largest investment banks, and I'll bet you those are good guys and I like them and I know them and I respect them, but I bet they couldn't devote very much time to it. They probably didn't understand what was going on, as much as they probably should have and wanted to. Time is a huge problem, so I think boards have to think about how to work smarter. Think about how they spend their time, how to use that precious time more efficiently in terms of their agendas and their schedules, and how to expand the time if they need to. But I would submit to you that if most boards spent some time just thinking about, "Are we focused on the right things? Have we got the right agendas? Are we doing the right stuff when we're together?" they wouldn't need more time. So that's why I call it the low-hanging fruit. I think that's pretty easy to fix and I recommend that you think about that on boards in which you're involved.

I think also we have to figure out how to improve information, particularly for the independent directors. You have to be clear about what you're trying to do. What are you trying to monitor? What decisions are you trying to make? Where are you trying to give advice? And therefore, what information do you need? And without going into a lot of detail here, I think this may be one of the biggest problems boards face. They just have a terrible time figuring out what is really going in this company, with our businesses. It's not that they don't get information. Most managements are quite willing to give the board all the information the board wants and needs and probably more. I think one of the tactics CEOs use to confuse the board is to tell them everything because the directors can't figure it out. What we need is more focused information.

The directors need to have a very clear model of the business. What are the strategic and risk factors for those business or businesses? And they need to get data that is beyond the financial data. Too often all the board gets is the profit and loss statements, the balance sheet, maybe a cash flow statement. How are we doing against competitors? What do the customers think of our products? Where are we with new products, new services, and all those things? And I think the only other point I want to make here is that there's an immense potential with computers to get real-time information into the hands of directors. CEOs and CFOs and others have to learn that sharing that information is not going to mean that the directors are suddenly going to be running around trying to run the business. But I think if you develop the right kind of conceptual frameworks for information and use the computer to deliver it, boards will be very much better informed pretty quickly.

Group decision making

Now, the group. The problem, as we all know, is that boards are groups. We've gotten the size of boards down and I was pleased, but not surprised, that John Reed's first recommendation was to cut the size of the Stock Exchange board from twenty-seven to seventeen, I think was said in this morning's newspaper. And I think that's absolutely right. The smaller the board, the easier it is to get things done. Anybody who's worked in a group understands that.

But there are some other things that go on even with a smaller group. The first thing you have to think about is what's the job of the chair? Well, the job of the chair, it seems to me, is to assure that board members have knowledge, to manage the time within that meeting, to encourage discussion, and to encourage dissent in the discussion. One of the things I find absolutely fascinating is that these CEOs and chairmen who run large companies and do it very successfully have a terrible time running a meeting of twelve people or ten people. They just can't figure it out. They get all confused and they just don't know how to keep this group really working well. And one of the things I think we probably should do is run a program for CEOs and chairmen about how to run a meeting. They seem to be able to run a meeting with their subordinates when they're clearly the boss, but as I'll point out in a moment, they aren't the boss and that makes this whole problem of leading the meeting quite a bit more complicated for them.

I think members have to be responsible. They have to understand the schedule. I get so furious at directors in meetings who spend twenty-five or thirty minutes explaining to the other board members how smart they are and "how we do it at my company." It's a waste of time. So the directors have a responsibility to use their time intelligently. And they also need to be careful that when they've got managers in the room they encourage the managers' contribution and don't skewer them. And that they really understand that the purpose of the meeting is to reach a consensus and try to work to help other people understand where you're coming from and how we can work together.

Relationship between the board and the CEO

Now another thing I think is probably the biggest problem in this arena is the relationship between the board and the CEO. And I mentioned it earlier. Let's understand that here in America, and I can give you a talk, if you want, about why the British system of having a separate chairman is also flawed. But let's just focus on ourselves for a moment because I assume most of you are Americans. Am I right? No, I'm wrong. I know you want to talk about this; we'll talk about it in a minute. But in the United States, we have this situation where the CEO and the chairman are the same person. And that really is truly like the fox in the chicken coop. So how do we deal with that? Well, I think the first thing you have to do is to have this independent leader that I mentioned earlier.

Need for explicit goals
But I think even with that in place, the board and the CEO need to agree on what their goals are. Where are we trying to go? It's not just a question of shareholder value, probably, but it's shareholder value and company health and how they relate to each other and what time horizons we're trying to achieve these things in.

I think you also need to be explicit about the responsibility of the board and the responsibility of the CEO and about the relationship between these people: the chair, the CEO, and the lead director, if there is such a person. And that to me is probably the most critical thing of all. Because what you don't want to see is these three people or these two people getting into an argument, and constant arguments and fights with each other, because that's destructive.

Now I think you also need to be sure that the board does have independence. There's all this talk about independent directors and how do we create independent directors? Frankly, I am less concerned about independent directors as individuals than I am about independent boards, if you understand what I mean. And I would love to have some people on the board who really know something about the company and are not technically independent. But if the whole board is independent—has its own independent leadership, these directors meet alone and the board is capable of independent action, independent from the CEO—then I think we're going to get better governance.

I think you periodically need to look at this complicated relationship and I think you need to understand that we can make it work; it does work in a lot of companies. So in the end, what I'm saying to you is that new laws and self-regulation can help, but the key to overcoming limits in dealing with these challenges is in the hands of each board around getting clear roles, defining the roles, and improving your design.

Designing Boards
Now I come to the future here a little bit. We've just written a new book called *Back to the Drawing Board: Designing Boards for a Complex World*. And the idea that we have here—and my co-author is one of Shann's countrymen and one of our alumni from Australia, Colin Carter—the thing we really were trying to explain in that book is that boards, first of all, faced a lot of challenges: new laws and expectations, increasingly complex technologies, increasingly complex companies, and changes in markets and technologies.

What I want to talk about is what we mean by design, because our argument here is that within the laws and regulations, boards have a lot of room to make choices themselves. And that's basically what I was arguing before when I said you could fix the way you use time. You can fix the way you get information. You can fix the leadership problem. And what we're saying here is that you can think about a board in relation to its company and design these elements: the composition and size of the board; the necessary committees, because you may want committees beyond the three required ones; the kind of leadership structure you're going to have—Chairman and CEO, separate chairman, separate CEO, lead director; the way you think about agendas and meeting schedules; the way you get the board to build knowledge and understanding; the processes used for decisions and for making and assessing policies; and obviously the kind of compensation the directors get because that may have something to do with their motivation. If you get those things designed correctly, we think you can improve board behavior in a lot of boardrooms. And the design, we think, must fit the company, its complexity, and the way it's performing. You may need one kind of a board for a company that's in deep trouble or with a new CEO. A different kind of board design may work with a company that's doing very, very well with an established, well-experienced CEO.

I think it also has to fit the board's resources. And what I mean by that is simply that your design has to recognize the constraints of time and knowledge of the people in that room. Because you can't ask these people to do more than they're capable of doing or to do something that they don't really have the knowledge to do.

Summary: The Big Questions
So finally, let me end with what I think are the four really big questions that I'm not even going to try to answer, but they're out there and they're going to be part of this debate over the next years.

Are shareholders owners?
First of all, there's this interesting question: are we right in considering shareholders owners? Marty Lipton and one of his colleagues, one of his partners, Steve Rosenblum, have just written a paper in which they make a very powerful argument that shareholders are not really owners in the sense that people own a car or you own a house. And the reason this becomes an interesting question, particularly in the United States, is that we have so much churn in public ownership. The average holding period in a New York Stock Exchange company is less than six months. Think about that. Every share of a New York Stock Exchange company, on average, turns over every six months. The problem directors have when I talk about figuring out what their goals should be is that they don't know who the shareholders are from one meeting to the next in most cases. And they have to try to figure out what is it that shareholders want. Even if they know who they are, they may not know what they want. So thinking about shareholders differently may be an interesting question to pursue.

Focus on corporate performance and shareholder value
I think another big question is how to return our corporate governance system—and in fact our economy, our business economy, the business aspects of it—to a long-term focus on both corporate performance and shareholder value. It used to be that companies were thinking about what do we accomplish and what do we build over the next two years, three years, five years, ten years? And today we've got this huge emphasis on this quarter, next quarter and so on. Long term right now is next year.

Dealing with CEO compensation
I think a third big question, and one that may be the hardest one to get any answers to, is how do we get the compensation genie, particularly as it pertains to CEOs, back in the bottle? There are two problems there. One is that the average American CEO now gets 500 times as much as the average employee of his organization. Five hundred times as much! And the relationship between CEO performance—between CEO pay and company performance—has been shattered in too many places. I'm not saying it's true across the board, but there's too much of that and I think it's going to become a huge political issue, particularly in a country where, in general, we are seeing a more skewed income distribution. The middle class and the lower class are not going to stand for this for very long, my prediction. So somehow we, the responsible business leaders, have to figure out what can be done to get this back under control.

Confidence in information providers
And finally, I think overall we have to think about how to provide confidence in the integrity of those people who provide information to you, the investors, or any of us who are investors. And that really focuses on analysts, it focuses on auditors, and maybe even on the press.

I thank all of you for coming and hope you learned something. I think I have. Thanks very much.