

CORPORATE ACCOUNTABILITY AND CORPORATE POWER

by

Harold M. Williams, Chairman



Securities and
Exchange
Commission

A Paper Presented at the Fairless Lecture Series
Carnegie-Mellon University, Pittsburgh, Pennsylvania

October 24, 1979

In an essay only recently discovered, Albert Einstein describes what he characterized as "the happiest thought of my life." That idea was basically the recognition that out of seeming contradiction, inspiration and creativity often flow. Einstein derived this proposition from his struggle to rationalize Newton's theory of gravitation and his own concept of relativity. He was able to reconcile both theories as a result of an obvious, if startling and far-reaching, insight -- that a person falling from the roof of a house is both simultaneously in motion and at rest. He wrote:

"For an observer, in free fall from the roof of a house, there exists, during his fall, no gravitational field * * * in his immediate vicinity. If the observer releases any objects, they will remain, relative to him, in a state of rest. The observer is therefore justified in considering his state as one of 'rest'."

Although this hypothesis is superficially unreasonable and contradictory, it has in it the seed of a superior and powerful logic which can accommodate both Newton's view and Einstein's in the same overall conceptual scheme.

This notion that the reconciliation of contradictions may be the impetus to creativity is one which, I believe, is also relevant to the topic of this afternoon's lectures -- the struggle to rationalize the various views towards corporate accountability and corporate profitability. At minimum, if contradiction is the stuff of creativity, then there is certainly abundant reason to hope for intellectual progress in this area. Moreover, as in Einstein's hypothesis, different conclusions may simply reflect differences in the observer's own position. The debate over the relative merits and abilities of inside and outside directors, differing views of the balance between the private and quasi-public responsibilities of corporations, and disputes concerning the proper role of the shareholder in corporate accountability all suggest that the subject is sufficiently complex and multifaceted that a wide range of contradictory theories, each with its own grain of truth, can be distilled from the experiences and preconceptions of different observers.

Perhaps the most basic contradiction is the high level of interest, on the one hand, in greater government-dictated control over what our large corporations do, and on the other hand, the strong current of public sentiment for less government involvement in all facets of private activity. I am not optimistic that this particular contradiction will necessarily resolve itself in business' favor. Present economic problems -- particularly inflation, unemployment, and energy -- may damage American business much more than the regulatory reform movement will aid it. The American people cannot experience disappointment in their economic goals and aspirations without

reacting negatively against American business. The tendency is to assume that if economic expectations are not met, the cause is that business -- the vehicle of our economic progress -- has somehow channelled its power to serve its own ends rather than the public's. If this seems implausible, consider the recurring suspicion and hostility toward the oil companies and the way it clouds and confuses the ability or willingness of the public and the politicians to conclude that the energy problem is real and to perceive the role of the oil and gas companies in the solution.

I would, therefore, like to take as my theme today the way in which this contradiction can be resolved consistently with both public expectations concerning the accountability of corporate power and with the health and stability of our private economic system. While the search for such a resolution will not be an easy one, in my view, the only hope for an answer consistent with private enterprise lies in the ability and commitment of the private sector to take the initiative in structuring effective mechanisms of corporate accountability. During the past decade, the ability of business to shape the issues and to limit the governmental response to that which is logical and consistent with the continuation of a healthy and vital private sector has been limited, at best. And, at the same time, there has come to be a growing public sense that business no longer attempts to balance its interest and the public's, but rather focuses entirely on its own narrow objectives.

The findings of one firm which has done extensive work concerning public attitudes toward business illustrates this skepticism. In 1968, Yankelovich, Skelly and White found that 70 percent of the respondents in a national survey agreed that business tries to strike a fair balance between profits and the public interest. Only two years later, in 1970, that figure had dropped to one-third. It reached a low point of 15 percent in 1976 -- an 80 percent loss of support over eight years. And, it has not recovered significantly in the years since 1976, with readings of 15 percent again for 1977, 17 percent in 1978, and 19 percent in the most recent survey. Similarly, in 1978, only 15 percent of the public regarded corporate executives as "very credible"; 36 percent considered them "not credible." On the other hand, one of business' best-known critics, Ralph Nader, received a 44 percent "very credible" rating -- the highest of any person or group in the various categories surveyed. Television commentators, at 40 percent, were close behind. *

If these survey results, and others like them, are an accurate reflection of confidence in our private economic system, then it is not difficult to understand why the political process frequently seems insensitive to measures which

* Yankelovich, Skelly and White, *Report to Leadership Participants on 1978 Findings of Corporate Priorities (1979)*.

would improve the health of the private sector. And, correspondingly, it is these kinds of perceptions of business and its leaders which business needs to change.

i. The Issue -- The Accountability of Power

At the outset, it is useful to explore why the accountability of corporate power is an issue in our society today. Quite clearly, the American economic system has propelled us, in less than 100 years, from an underdeveloped, primarily agricultural country, to a society of mass wealth and mass consumption. In the process, we have raised the standard of living in much of the rest of the world along with our own. This unprecedented phenomenon is a direct result of our private enterprise system. Moreover, wherever countries of comparable resources are compared, the economy with a significant private sector has clearly done more in fulfilling the aspirations of its people than its nonprivate counterpart. Compare, for example, West and East Germany, South and North Korea, or Austria and Czechoslovakia. In the face of this tremendous success, why should any question arise as to the "accountability" of corporate power? A more natural reaction would seem to be, in the words of a former Office of Management and Budget Director, "If it ain't broke, don't fix it."

A. The Demand for Accountability

In my view, the answer to this particular contradiction lies in the fact that we have a deep-seated conviction that anyone who exercises power needs to be accountable to someone else for his stewardship. Most people would, I think, regard it as self-evident that anyone who is not accountable, whose word is final and who is not subject to review and risk of removal for failure to achieve acceptable results, may, over time, become autocratic, arbitrary and arrogant. History teaches that the unfettered exercise of power will often tend to result in a loss of contact with reality, insulation from unpleasant news and increasingly insensitive and irresponsible judgments. The institution becomes an end unto itself, out of touch with its relationships and its responsibilities to the rest of society. Such a situation is destructive of the institution involved and those it impacts and is morally unacceptable.

There is a concern on the part of too many to ignore that this syndrome can and is occurring in aspects of American business. The question then is whether the structure of accountability in which modern corporate management operates is adequate, in both theory and practice, to meet that concern. And, to a degree, the issue is not whether corporate power is, in fact, frequently abused to the detriment of the public. Rather, the crux of the

problem is whether the public can reasonably perceive that to be the fact. Business would be well-advised to bear in mind this distinction between reality and public perception as the debate over corporate accountability proceeds. Over time, no activity can flourish if "the public" takes a dim view of it. Over a longer term, no activity can continue unaltered if public apathy or distrust become active antagonism.

B. The Withering of Traditional Checks

I do not believe there was ever a golden age when business was admired or accepted -- or even well-understood -- by the majority of any society. In the minds of many morally-sensitive people, markets have always been regarded as inhumane and unjust, and often even capricious. Efforts to improve one's position have been regarded as socially disruptive, and trade as less honorable than other occupations. Traditionally, however, two answers have served to alleviate concern over the question of whether economic power is accountable.

The first prong of the response has been that the discipline of the marketplace checks, and ultimately destroys, those who are irrational in the exercise of corporate power. Whatever force it may once have had, however, this hypothesis has lost most of its vitality -- at least for the largest corporations. The difficulty is that the theory presupposes an open economic universe which is no longer the reality. We have substituted for that open universe of free competition a business environment designed to insulate against the hazards of a 19th Century economy. In fact, even what is left of the argument that the discipline of Wall Street will ultimately result in an inadequate management's replacement is being rapidly impaired by corporate defensive charter amendments and other similar measures which, in many cases, effectively eliminate the discipline imposed by the possibility of an unfriendly takeover. While some have questioned their efficacy, charter amendments requiring supermajorities to alter corporate by-laws, the staggering of director terms of office, and similar devices serve to insulate management from the possibility of ouster by an outsider -- regardless of the performance of management or the price the outsider is willing to pay.

Overall, this new economy is a combined private and public one with a myriad of risk-minimizing devices. This development may well be inevitable, given the social disruption which the collapse of a Lockheed or a Chrysler would spawn. The point, however, is that in such an environment, an appeal to free enterprise as a justification for the lack of formal checks on corporate power is largely rhetoric used to preserve the autonomy of management rather than a significant comment on issues of public policy. Too often businessmen have been willing both to use that rhetoric when it serves their purposes and to seek protection from the perils of the marketplace when it does not.

The second argument most commonly used to challenge the need for mechanisms of corporate accountability rests on the theory that the board of directors, as the shareholders' surrogate, acts as the watchdog of management power. Again, however, the facts do not adequately support the theory. While the record of board performance is difficult to isolate and study, it shows that directors seldom turn ineffective management out and react exceedingly slowly to corporate deterioration. Boards have occasionally asserted themselves, but such activism is rare, though increasing significantly. In his testimony before the SEC on September 30, 1977, Myles Mace pointed out that, for example, when boards have fired a chief executive:

"the leadership of the [incumbent] was so unsatisfactory that even his mother thought he ought [to go] for the good of the company * * * before the board reluctantly moved."

Correspondingly, stockholder discontent is more frequently reflected in the sale of the company's stock rather than the rejection of its directors at the annual meeting.

As a result, it is possible in many companies for management to limp along until either economic setbacks are so severe that change is compelled or until a large investor or company, recognizing that the corporate assets can produce better profits, wrests away control. In the former case -- when reported profits decline to such an extent as to threaten the security of their position -- some managements are tempted to change the accounting practices, earnings figures, or morals of the company in order to delay the inevitable by presenting a more acceptable profit picture. And, in the later case, by making a bid for control more difficult, we neutralize one of the remaining disciplines on corporate management.

What is missing from this environment is a force that has the practical capacity to effectively oversee management, and if necessary, make timely changes. To the extent that the public perceives this accountability gap -- and concludes that it has suffered serious consequences because of it -- the pressure mounts for government to be called. I have little confidence, however, in government's ability to be prescriptive concerning corporate mechanisms without also being so oppressive as to destroy them. Thus, in looking for solutions, we need to concentrate on improving the overall effectiveness with which the present system functions, rather than experiment with a totally new system of accountability. The issue is how to preserve the advantages of a strong management-based corporate system and still be assured of effective institutional discipline. In my view, the answer is to be found in the corporate board room.

II. The Role of the Board of Directors

A strong and effective board is a valuable corporate asset. Enhancing the perception of corporate accountability and thus reducing the pressure for a government role in corporate decision-making is a vital goal. However, both management and directors also share another, more fundamental, goal - to develop a board which can bring the best, most informed and most objective advice available to bear in solving the complex problems which confront the company and American business today. If directors are timid or feel compelled to compromise rather than advocate their views forthrightly - whether because of their personalities, their friendships, or their pocketbooks - then, in the long run, the corporation is the loser. And the officers and directors may be the losers as well, since they may not be able to point to the kind of disinterested decision-making which underlies the business judgment rule. Viewed in this light, the benefits in terms of public credibility which would flow from more effective accountability are secondary to the value which the corporation can derive in practical, day-to-day terms from a vigorous and thoughtful board.

In suggesting that an independent source of discipline is missing from many corporate environments, I do not mean to ignore the very real progress which many boards have made. Indeed, some boards already function most effectively, and many others are exploring ways to strengthen their role. The changes that the board is undergoing, or has undergone, have served to protect the basic system and to demonstrate its ability to evolve. As I will outline in a moment, I believe the basic sociology of the board room dictates that those companies which are not already engaged in a searching examination of the role their boards could play should do so, and that further changes should occur. These changes are, however, within - not destructive of - the basic board framework.

It is important to recognize that board reform proposals - which some in the business community regard as radical - appear in a different light to many outside. For example, Professor Lewis D. Solomon, in his March 1978 *Michigan Law Review* article concludes:

"* * * [T]he problem of corporate reform is too complex and intractable to respond to so simple a solution as the reform of corporate boards. Our efforts to revive the board of directors are simply anachronistic; new methods must be devised if we are to make corporate management genuinely accountable."^{*}

* Solomon, *Restructuring the Corporate Board of Directors: Fond Hope - Faint Promise?*, 76 *Michigan Law Review* 581-583 (1978).

And, Peter Drucker, an academic, but certainly not an antibusiness ideologue, characterized the board of directors as an "impotent ceremonial and legal fiction." *

I do not personally share in the more cynical implications of these observations. On the contrary, I believe that the board of directors is the key mechanism within the corporate structure which can render unnecessary any efforts to impose accountability from without. But, as the comments of Professors Solomon and Drucker illustrate, it is by no means a foregone conclusion that boards will be able to reverse the trend of public skepticism toward the exercise of corporate power. Nor can I say that their skepticism about the way many boards function is misplaced. I do disagree, however, with the premise that the board, as an institution, cannot be made to work effectively, and disagree vigorously with the various proposed solutions which, in my judgment, propose a new disease worse than that to be cured. In my view, the board can serve to institutionalize effective accountability without bringing the hand of government down upon the corporate structure.

A. The Sociology of the Board Room

In order to fill its role, the board needs to focus on the sociology of the board room and to re-examine the role of the board and the individual director. Each board and board room is a mini-society. In some of these societies, the board is strong and effective. In others, it is passive and reactive. When a person becomes a member of the board, he must decide what his relationship will be to that society. If the mood - the social ethic - is one of disinclination to criticize, if directors are expected to ratify management decisions, and if inquisitiveness is interpreted as distrust of the chief executive and a violation of good corporate manners or protocol, the system breeds a tendency to rubber-stamp management, make comfortable decisions, and avoid confronting significant issues as long as possible.

When it occurs, this sociological climate derives not necessarily or alone from a quest for power or a management desire to be free of the discipline of oversight, but rather from two very normal, benign human traits. First, management tends to invite on the board people who are compatible, if not indebted, to the corporate chief executive officer and the management. Inside directors are the most extreme case of this phenomenon. Corporate employees cum directors depend on the chief executive, not only for their tenure on the board, but for their promotions and salaries, and are therefore disinclined to challenge him or management recommendations. Insiders can, of course, perform useful service on corporate boards. They can furnish information

* Drucker, *The Bored Board*, 1 *Wharton Magazine* 19 (1976).

and perspective to outside directors, afford outsiders a first-hand opportunity to appraise management, prevent a chief executive from painting an unrealistically favorable picture of corporate performance, and make board decisions more palatable to their fellow corporate executives. But insiders cannot, by definition, perform the function of holding management's exercise of corporate power accountable.

Outside directors – that is, directors not simultaneously employees of the corporation – may suffer from similar limitations. Outside directors also often depend on the chief executive for their position on the board and frequently have personal and business reasons for agreeing with him. Outside directors are often friends and social acquaintances of the chief executive or from the upper echelons of companies and professional firms patronized by, or otherwise economically concerned with, the corporation. The social and professional connections may overlap. They often do business together and are involved in the same community, charitable and social organizations.

A second factor which works against board effectiveness is the tendency of people who work together over a period of time to seek to create a tension-free, harmonious environment. This tendency pervades human society, and, indeed, makes society possible. But in the context of the board room, one of its consequences can be that, over time, the management's accountability to the board declines. Accountability, and the discipline it entails, threaten to upset the comfortable, harmonious relationships which we all tend to move toward.

We cannot ignore the consequences of these two factors – the tendency to select compatible directors and the avoidance of tension or discomfort. They represent a constant pressure to make the atmosphere in the board room congenial and to transform directors into sympathetic listeners rather than independent inquirers. Accordingly, we need to search for ways to institutionalize other pressures which will keep compatibility and accountability in equilibrium. The goal is not to transform managements and directors into adversaries, but rather to make sure that the board's effectiveness does not gradually erode in response to the pressures under which it operates.

B. Creating the "Ideal Board"

In speeches during the past several years, I have made a number of proposals concerning board composition, chairmanship, and committee structure which would, I believe, help to counteract these tendencies. The board construction I have proposed addresses what I consider to be the most common and objectively identifiable aspects of board structure and composition which can impede the effective functioning of the board. It obviously cannot deal directly with the matters that ultimately determine board effectiveness – the sociology of the board room directly and the personal qualities of individual

directors, whatever they may be. Yet, ultimately, the effectiveness of the board is determined by the those very factors - the attributes and ethics which pervade the board room.

For that reason, rather than repeat my board structure proposals, I want to outline the concerns which underlie them. My objective is to encourage boards to explore the issues and their implications and relevance to them.

First, it is important to consider the role and number of insiders on the board. By this I mean individuals who are either employees of the corporation or otherwise dependent upon it economically. That definition requires boards to focus on many traditional directors in addition to employees, such as corporate counsel, underwriters, bankers, major customers and major suppliers. I am not suggesting that these individuals are necessarily ineffective as directors or that self-interest usually clouds their judgment. As I pointed out above, however, the sociological and psychological factors which pervade the board room limit the ability of management members to perform the accountability function. Similarly, the "second hat" which corporate counsel and other "suppliers" wear with respect to the corporation raises an issue of whether their ability to contribute to both the reality and the perception of accountability is diminished. Stated differently, directors who have business links to the corporation impose a cost on the accountability process, and we need to consider carefully in each situation whether that cost is a necessary one to incur, and whether the benefits can be achieved in other ways.

Second, boards need to examine the role of the corporate CEO as chairman of the board. The ties which board members will feel to the CEO and their basic desire to be supportive are compelling. The consequences of adding to that power the power of the chair and of the agenda process must be weighed cautiously. The point is not that chief executives are untrustworthy when they hold the office of board chairman; in fact, the capability and integrity of the chief executive officer ultimately determines the success of the company. If the board or individual board members reach a point where they do not trust the CEO, they should either replace him or resign. Nonetheless, the intimidating power of the chair, especially when occupied by a chief executive to whom many on the board owe their directorships and perhaps their livelihood, is a factor which deserves serious consideration. Moreover, in the board environment, the role of the chairman's role is to create the kind of open, contributing and questioning environment which I have described. The CEO's role is to speak for management. These roles are not the same and can conflict.

The final broad issue which boards must consider is the specific responsibilities which the board needs to discharge and how best to approach these tasks. Board committees comprised of outside directors may have an important role to play in that process, especially when there are a significant number of insiders on the board as a whole. Audit, nominating and compen-

sation committees are particularly crucial. Audit committees are critical because of the fundamental role which the independent auditor plays in corporate accountability and the special trust which the public places in the auditor's work. With the wide acceptance of the concept of the audit committee, the next question which must be faced is the definition of the committees responsibilities. At present, many audit committees are, undoubtedly, not yet working fully effectively, and some may serve more to provide windowdressing rather than to add substance to the accountability process. The development of a better consensus as to the minimum responsibilities of audit committees should be an important priority.

A second important mechanism -- one less widely recognized -- is the independent nominating committee. For such a committee to be effective, it must concern itself with board composition and organization. It can thus be the vehicle to deal more objectively with the tradeoffs between the benefits of, for example, management representatives on the board and the costs of those representatives. As long as such decisions are in the hands of knowledgeable, concerned independent outsiders, I believe that the environment for the kind of accountability which I have been describing will be substantially enhanced.

More broadly, however, the most important responsibilities of the nominating committee should be to develop a process to assess how well the board is functioning, to evaluate the board and its members, and to select criteria for board candidates which mesh with the board's needs. For example, the nominating committee may legitimately look to other companies as a source of additional board talent. CEOs, because of their background, bring to boards the kind of perspective and experience which is desirable in assessing what the company is doing and where management proposes to take it. CEOs, and some other individuals with experience as members of a corporate senior management team, can also appreciate the concerns and the perspective of the company's CEO and the inherent separation between management and the board. At the same time, however, nominating committees should not conclude that only individuals with corporate experience -- those who have met a payroll -- qualify for board membership. Researchers, scientists, academics and many others may also have a valuable contribution to make toward achieving the company's objectives.

An effective compensation committee will also strengthen accountability. In addition to considering the appropriateness of the compensation packages for senior management, such a committee should, for example, examine key management compensation policies to assure consistency with the long-term interests of the company and to assess whether compensation practices encourage management to maximize short-term profit at the expense of long-term interests. Another aspect of this committee's mandate should be to consider the level of director remuneration. Compensation for directors is growing

- and properly so. The nonmonetary rewards of these posts, such as the prestige and the desire to do the board or its chairman a "favor," are not now as compelling - particularly when weighed against the increasing time demands and the risks of liability and other legal entanglements. Directorship is a responsibility rather than an honor or a courtesy, and should be regarded and compensated accordingly. All of these considerations should be elements of the compensation committee's work.

C. The Limits of the Board

Before I turn to the role of management in the accountability structure, I want to outline what I do not advocate for the board, since critics of my views seem to have a tendency to attribute positions to me which I have not taken. First, I do not favor constituency directors. In my view, the board is not a political body and cannot function effectively when populated by individuals who have special interests to champion and little concern or sense of responsibility for the overall welfare of the company. Additionally, some of those who advocate constituency directors seem to have in mind persons unconcerned with - or actively hostile to - the basic economic purpose of private business. For those reasons, I strongly oppose constituency directors.

Second, I do not desire or intend to convert the board room into an arena characterized by distrust of, or suspicion toward, management. I have sometimes used the word "tension" as a characteristic of the relationship which I visualize between management and the board. For some, this conjures up certain images I did not intend. The goal is an environment of accountability - not one of hostility. A chronically adversarial relationship between board and management would be equally as destructive of accountability as is a relationship characterized by board passivity. The board and management must be capable - within the accountability framework - of working with, not against, one another.

Third, I oppose federal legislation or regulatory action to charter corporations, to dictate board structure, or even to impose my own suggestions. My goal is to highlight my sense of urgency that corporations, their managements and boards assume the initiative in assessing the responsibilities of corporate boards and how they might better be carried out so as to strengthen the case against legislation, and make it unlikely - not to hasten its passage. While some apparently believe that legislation is the key to reform, I am concerned that federal encroachment into the board room would likely cripple rather than strengthen its functioning.

Legislation would, I believe, be crippling for two reasons. First, a statute will, by definition, impose one solution on all corporations. The flexibility to tailor the board to the needs of the particular corporation would vanish.

Second, legislation which sought to mandate "independent" boards or "independent" directors would of necessity focus on structure, form, and objective criteria, rather than on the intangibles that ultimately determine how well the board discharges its responsibilities. It would have the effect of diverting attention from the efforts of individual companies and boards to discharge their responsibility to do whatever is necessary to make their boards effective and of focusing it instead on mechanical compliance with the law. The legislation would not be effective, the consequences would not be desirable, and would likely spawn further, more restrictive, legislation which may ultimately preclude both the possibility of boards functioning effectively and the ability of managements to deliver the results necessary to assure our economic and political future.

Finally, I am not suggesting that the board's power over corporate business expand at the expense of management's. The appropriate and most productive function of the board is to monitor, not to manage - to support, to guide, and where necessary, to discipline, but never to usurp. To the extent that effective functioning of the board cuts back on management autonomy, the board is assuming a role it had previously abdicated - not usurping a management prerogative.

III. The Role of Management

I want now to turn to corporate management. In the debate over enhancement of the corporate board, it is easy to lose sight of the fact that the success of American business and its contribution to our nation's future economic health will continue to depend primarily on the ability and effectiveness of corporate management.

A. Management and the Profit Objective

In considering the role of management, it is crucial to recognize at the outset that management's primary mission is economic and that the key to the success of any corporation is the capability of its management to carry out that mission. The purpose of the corporation is to provide customers with goods and services at an attractive level of quality and price. The profitability of the corporation is, over the long run, a measure of its success in discharging that underlying responsibility, rather than an end in itself. The profitability of corporations as a group is a measure of our society's success in providing jobs, goods, services, prosperity and other economic underpinnings of the political freedoms which make our democracy possible.

It is the quality of managerial leadership, its willingness to venture, take risks and seek rewards, which will determine the future of individual businesses

and of the economy as a whole. No government rule, no board of directors, no federal agency, can offset the consequences of an inadequate management – and all of these must guard against usurping the management role or crippling an able management. Because, however, of these and other pressures on business executives, there is always a danger in today's climate that some managements of their own volition will not risk being second-guessed or failing and will tend to "play it safe" at the expense of the primary economic mission. Such an approach is not consistent with the kind of risk-taking venturesomeness necessary to the future of American business and the American economy.

In opposition to proposals to change the accountability framework in which corporations operate, the argument is sometimes made that the entity is accountable to its shareholders and that their interests must be paramount. In my view, that concept is correct, but the definition of shareholder which its proponents use is not. The "shareholder" to which management should regard itself as accountable is not simply those individuals who happen to be shareholders today – or at any arbitrary point in time – but to "ownership" as an institution over time. When the "shareholder" is viewed as a continuing, long-term group – even though its membership is changing daily – there is far greater congruence between corporate activity in the interests of its shareholders and the interests of the larger society. Concern for how a company can contribute over time to serving today's needs for goods and services in a competitive economy is an effective antidote to the tendency to make expedient short-term decisions.

B. Profits and Business Ethics

Given that profits are a management's most fundamental responsibility, the question arises to what extent pursuit of that goal is to be impacted by ethical standards, and if so, how these standards are to be established. Here again, there are those who look upon the corporation as engaged in activity which is essentially economic, and as such, to be judged by its success in the marketplace, limited only by its obligations to obey the law.

Simply stated, good management concerned for the future of the company achieves a harmony of profit and other goals; indeed, there is a very strong correlation between companies which think and respond in terms of longer-range corporate responsibilities, including social and political overtones, and those with the best performance records over time. The converse is also true. Managements which fail to think in terms of the broader social dynamics in which they operate are unlikely to anticipate changing customer needs and therefore are not likely to prove successful over time.

It is clear to me that individuals functioning in a corporate capacity – both individually and collectively – have as great a responsibility to conduct

themselves ethically as they do in their personal lives. They do not and cannot absolve themselves of that responsibility by assuming a corporate mantle and by asserting that their efforts should be judged in economic and profitability terms alone. As a practical matter, it is the individual who must be held accountable - not some amorphous thing known as the corporation. The corporation has no morality or immorality, no values or ethics, separate from those of the individuals who make it up. Actions attributed to business firms are performed by individuals, and they should be considered personally responsible for whatever business firms are accused of doing. It is the individual executive who decides whether to act morally or immorally, ethically or unethically. Consequently, it is impossible to separate the social environment of the firm from the ethical standards of the executive who manages it. The executive inevitably finds that his own moral code is the bottom line in his business decision-making, and it is not realistic, either psychologically or ethically, to expect the individual executive's actions as a businessman to be inconsistent with his personal sense of responsibility to society at large and to his own conscience. To contend that one can live a personal life by one set of ethical standards and a business career by another is either self-deception or hypocrisy.

Management, however, frequently and unwittingly creates a climate that tempts subordinates to compromise their ethics - not on their own behalf, but on behalf of the company and the company measurement of performance. A company, in order to be prudent and moral, must be careful to avoid creating ethical conflicts for its employees. One management, in the course of developing a code of conduct for its employees, was shocked to learn from them the number of people in the firm who had faced a wide variety of serious ethical dilemmas and handled them on a case-by-case basis with no guidance from top management. But more importantly, most cases had been resolved in favor of the course that would produce the greatest short-term profit. Management discovered that a number of expedient practices had been prevalent because of two employee attitudes. First, the company was perceived as always having placed great emphasis on rewarding those who made the largest contribution to profits. Second, the firm had never evidenced any special concern for ethical standards. Consequently, most employees naturally concluded that cutting corners in order to maximize profits was a condition of employment.

The lesson of this example is that top management must set the moral tone in any organization, and it must personally see that the staff remains on course. If the standards of top management are high, the chances are excellent that the standards throughout the organization will be equally high. But if those at the top do not have high standards, or if they violate the standards, there is an ever-present danger that more honorable persons below will be influenced by attitudes of those above them, and the organization's tone will reflect it.

Subordinates quickly discern the standards of their bosses and tend to act accordingly. Thus, do not be surprised to find that if you permit a man to steal for you, he later steals from you.

This is the core of the debate over corporate accountability. If an individual is in a business setting in which every action is justified on purely economic grounds and in which rewards and punishments are based on short-term economic performance, then, quite naturally, he will shape his conduct to maximize the economic returns of the entity, even at the expense, if need be, of other social or ethical values. The result may be positive in the short run. Over the longer term, however, business may destroy itself if it pursues that course. I do not believe society will tolerate, permanently, a major institution in its midst which justifies itself solely on economic terms. Nor do I believe that people who staff the entity will be able, indefinitely, to pursue conduct in their business relationships which is not consistent with other dimensions of their lives.

IV. Initiatives Toward Private Sector Leadership

I stated at the outset that my theme today was the need for the private sector to assume the leadership role in corporate accountability. That challenge – which is independent of the specific board structure proposals – should be the concern of every member of the business community. In the fast analysis, the future of the private enterprise system will be, and is being, determined every day in the board rooms of America. Boards will decide, issue by issue, how to allocate resources, when to venture and risk, whether to act in an expedient manner in the short-sighted interest of the company, or whether to seek solutions consistent with the longer-term interests of the company and with preserving the system. But even though the board room will be the decisive battleground in the struggle to retain the initiative over corporate accountability within, rather than without, the private sector, there are significant steps which business and professional leaders can take outside the board room to influence that struggle.

First, the private sector can provide more and stronger leadership for itself through its own existing organizations – such as the Business Roundtable and the Conference Board – or new ones especially formed for the purpose. The task is not an easy one, since the objectives of such groups must orient more toward providing leadership, rather than building consensus, if they are to be effective. Individual businessmen and associations of businessmen should speak out on the standards of business – not as defenders of business whether right or wrong, and not from a parochial view of a trade or industry association. Rather, businessmen should seek to develop standards to which all business would be expected to subscribe. To the extent that the private sector can

establish the bench marks of what is right or wrong, it is more likely to be able to prevent legislation of the type on which the public will insist if self-policing is perceived to be ineffective. More broadly, the picture of business leaders taking strict positions on business standards can provide a vehicle and a direction for restoring public confidence in the role of business in our society.

Second, business leaders should encourage the stock exchanges and other formal self-regulatory bodies to continue to provide leadership regarding minimum standards of accountability. The New York Stock Exchange, for example, has taken an important first step in this area by requiring audit committees of outside directors as a condition of listing. Other self-regulators are considering similar action. Although there is tremendous potential, there has not been enough systematic focus in the corporate community on the role which self-regulatory bodies could take in pre-empting the need for legislation.

In fact, the time may arrive to create a new private sector self-regulatory body with the enhancement of accountability and the articulation of the minimum norms of corporate conduct as its exclusive function. This is not a model with which we have had much experience. Yet, voluntary bodies – such as, for example, the National Advertising Review Board – are functioning in other areas. A corporate accountability body, formed in and by the private sector, might serve as an effective means to return the initiative to business. Lest the reports of this talk characterize me as advocating a formal self-regulatory body to regulate corporate conduct, let me make it clear that that is not my objective. I am trying to stimulate the ingenuity of the private sector – which will be brought to bear once it is convinced that a problem exists that needs solving – to devise creative and effective institutional methods to assist in achieving the desired result. Ultimately, I hope that through these efforts and others, we can reach a point where, for example, the meaning and importance of what constitutes an independent board is well-established, and its significance so clear that a company will be compelled to respond to its peers, investors, lenders, analysts and others if it does not appear to conform to the prevailing standard.

Third, business needs to find better ways to articulate its concerns and to describe its efforts to respond to the need for better accountability. When systematic progress has been made, we should not be reticent to publicize it. While the focus of this paper is on the need to improve corporate accountability, there are many examples of effectively-functioning boards and of efforts to improve – more so than advocates of change are willing to acknowledge. This needs to be communicated to shareholders and the public at large. Similarly, where business can make a case that particular regulations or legislative proposals will hamper it in discharging its responsibilities to the national economy, business leaders should not be reluctant to present their point. While business' credibility is sometimes suspect, there can be little hope

of educating the public if the effort is not made.

Fourth, professionals, whether they be lawyers or accountants, both individually and through their firms and associations, should be involved in informal standard setting. Lawyers, for example, have always been in the vanguard of any discussion about the role of corporations. Even though the most significant issues concerning corporate and shareholder conduct are policy questions which do not turn on the interpretation of legal rules, lawyers play an important role in shaping that conduct. Counsel to the corporation has influence which goes well beyond providing answers to technical, legal issues. He is, in fact, a policymaker. His professional training should equip him to raise ethical questions and he should be questioning his client about the appropriateness of its conduct. Similarly, if history is any guide, new corporate models and structures, responsive to the need to harmonize the expectations of society with its economic goals, will be shaped largely by lawyers. Thus, lawyers have an important role in guiding private sector accountability initiatives.

Further, institutional shareholders have a part in vitalizing accountability. At present, individual shareholder participation is not particularly effective. Many shareholders are primarily speculators in the income stream of the corporation. They are interested – so the argument goes – primarily in the short-term performance of the corporation, and if they are not satisfied, they will react by selling their stock. In other words, such shareholders do not behave as long-term owners.

At the same time, however, the role of financial institutions as the major stockholders of larger American corporations is growing. Their voting power is such that they cannot realistically be neutral on matters that call for shareholder consideration. Short of a decision to sell the stock, what are the obligations of institutional investors? Do they routinely support the corporate recommendation, do they vote their own judgment, or do they abstain? Any course can strongly influence the board's and management's attitude and the result.

Finally, business must do a more effective job of relating to government. Government needs to have a better understanding of the impact of social legislation on business and of the price which is paid in terms of productivity, innovation, and capital formation when regulatory schemes nullify the rewards which have traditionally flowed from risk-taking. The job is not an easy one since business' imput will be seen as self-interested and suspect. Nonetheless, this is an area in which government has a desperate need for information which business can best supply. Business will be more credible, of course, if it also takes stands which do not serve self-interest. This is a task to be undertaken by business leaders – by CEOs – not by the corporate governmental affairs officers alone, and one which can only be effective when part of a continuing

program commenced long before a particular problem has escalated to crisis proportions.

V. The Role of Government

That thought brings me to the facet of corporate accountability which I want to touch on last. Although, as I indicated earlier, I am opposed to legislation which would dictate the parameters of corporate accountability, I do believe that government has a role to play in the evolving accountability process. The struggle between government and business has become so deep-seated that many have come to perceive them as natural and permanent antagonists. However, if government and business are seen as natural enemies, then business as we know it has no long-range future. Government, as the only social institution that can legally enforce its will, must win any struggle if the issue is reduced to one of power.

A more realistic and constructive approach to the relationship between corporate accountability and government would begin by identifying the many ways in which business and government depend on each other. For example, modern business requires a level of social order and enforcement of the rules of the game that only the state can provide. Similarly, government, in our society, depends on business as the instrument of economic policy - the employer, producer and taxpayer which makes possible achievement of our society's economic goals. If business is to continue to have this role, rather than have it usurped by government, it must have public trust in its integrity and legitimacy.

While I oppose federal legislation or regulation which would dictate corporate structure, the modern corporation is, in my judgment, partially dependent on the federal government's ability to create the tools with which public trust and legitimacy can be built. The federal securities laws are a good example. While it is not my purpose today to defend everything which the Commission and the courts have done under the banner of these statutes during the past 45 years, I believe that the philosophies of full disclosure and of fair and open corporate suffrage have helped to preserve public confidence in business. Obviously, the securities laws also impose costs - at times very heavy costs - on public issuers. These costs are, however, I suspect small indeed compared to the costs which would have flowed from the substantive restraints which the public would likely have demanded if disclosure had not been adopted as the regulatory framework in 1933 and 1934.

I do not pick the federal securities laws as my illustration because I believe they are flawless. I do think, however, that they highlight a reasonable role for government in creating a framework in which corporations can build public trust. If the tide swings in favor of corporate governance legislation of the type

which some proponents have discussed, I fear that government's role with respect to the accountability of private corporate power may take a very different and more substantive tack.

Government, for its part, needs to appreciate the consequences of substantive corporate accountability regulation and the likelihood that such regulation would not achieve its intended purpose. Regulation in this area would, in my judgment, focus attention on private sector compliance with the form of government rules and regulations, rather than on how to get individual boards to function effectively. It would convey the message that boards that conform are "effective" and those that do not are "ineffective" - judgments which may bear no relationship to reality. When events prove that the legislation itself was ineffective, attempts would be made to tighten it up. There is little history of government, once it starts down a legislative or regulatory road, acknowledging that its course was in error, repealing the legislation, and retreating. Even when it does, the intervening damage is usually heavy and difficult, if not impossible, to repair.

VI. Conclusion

I opened my remarks by urging that the private sector take the initiative in shaping the mechanisms by which the exercise of corporate power is subjected to accountability. Although much remains to be done, business has clearly made tremendous strides over the last several years, as the work of the Business Roundtable, the ABA Committee on Directors Responsibilities, and many other groups demonstrates. While I am deeply concerned that the time within which to move further toward this goal is limited, there is nonetheless certainly grounds for optimism. For example, Ken Andrews, in his Harvard Business Review article, "The Roundtable Statement on Boards of Directors," closes with the observation:

"The expressed willingness of the SEC and the possible assent of the FTC and the Congress to look to boards of directors as the legitimizing institution for the responsible use of corporate power are encouraging at a time when some critics are ready to rush into more regulation.

"The Roundtable report is now in the hands of the chief executive officers, board chairmen, and independent board members who may be moved to adopt its spirit and apply their own energy to deal with the residual tough problems it omits. In the interests of our economic system and con-

tinued corporate autonomy, I hope the Roundtable traces among its own members the progress of its precepts." *

Even if boards are fully successful in this legitimizing role, society cannot expect "zero defects." Corporate failures and instances of impropriety will still occur. Thus, the test cannot be the perfection of the result, but the integrity of the system and its ability to self-correct and self-police the inevitable breakdowns.

There is a moral tone in much of the criticism which has been levelled against business in the past. The central issue is integrity, and much will depend in the coming years on the forthrightness and courage with which business faces up to that issue. At the same time, however, America's economic vitality is its greatest asset. It is the product of the creative spirit of a free and industrious people and of an economic system that gives opportunity to private initiative. It is the foundation of our prosperity, our political freedom, and our constructive relationships in a world of peace.

Nothing which is done, either in the private sector or government, in the name of greater corporate accountability should be permitted to destroy that economic vitality. I am confident, however, that the contradictions and dilemmas inherent in the evolution toward more effective accountability can be resolved in a fashion which is consistent with - and indeed enhances - our economic strength. The challenge of finding those solutions, and pre-empting intervention from outside of business, is one which will demand the time, commitment and talent of everyone concerned with our economic and political future.

* Andrews, *The Roundtable Statement on Boards of Directors*, *Harv. Bus. Rev.* 24, 38 (Sept.-Oct. 1976).