

THE REAL ISSUE: ACCOUNTABILITY AND RESPONSIBILITY

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I always approach an audience such as this with some trepidation, because I am constantly amazed at the breadth of knowledge and information that lawyers, and securities lawyers, particularly, seem to have --indeed, must have-- at their fingertips.

Some of you may have seen The Washington Post's recent reprint of an article on lawyers and the judiciary in this country that originally appeared in the prestigious French newspaper, Le Monde. In that article, the author stated unequivocally that "American lawyers come as close to being a 'ruling class' as is possible in a country too vast and varied to produce one." So I don't feel at all lonely in my admiration for your profession.

Indeed, my colleagues on the Board of Directors of the New York Stock Exchange share that admiration. As you know, one of the Exchange's key constituent groups is the more than 1,500 corporations whose stocks are listed for trading in our marketplace. And when corporate governance issues started attracting public attention, we invited a group of distinguished members of the bar to form a Legal Advisory Committee to give our Board, on a pro bono publico basis, the benefit of their perspectives on those issues.

Over the past two years or so, that Committee has, indeed, contributed a great deal of very valuable input on these and many other issues.

THE ISSUE OF THE 1980S

Corporate governance has been called the issue of the 1980s. Some critical observers of the current American business scene insist that there is an overriding need to assert greater Federal control over what they view as the excessive power of U.S. corporations. Others believe, just as strongly, that business --not government-- holds the key to re-establishing the growth patterns needed to ensure that all Americans in the years ahead will be able to enjoy the benefits of the very special blend of social justice, political stability and economic abundance that is our national heritage.

The dialogue to date has dealt principally with proposed legislative remedies for perceived problems. And most of those proposals have assumed that if abuses exist, the way to eliminate them is to devise statutes that will require corporate boards of directors to be more responsible and more independent -- whatever those two adjectives may really mean. And most of the dialogue has been of the unedifying "yes you should -- no you shouldn't" variety that all but ignores the underlying considerations that really determine the suitability of an individual to serve on a corporate board.

It is a simple fact that a director who can pass whatever mechanical test of independence you choose to devise may turn out to be a dud; while a director who fails the same mechanical test may be

a star -- the point being that you cannot legislate ability, intellect, experience, ethical standards or any of the other qualities that distinguish an effective, responsible, truly independent corporate director from a well-meaning, ineffectual ninny.

In any case, it seems to me that when you begin examining any issue in the context of possible legislative remedies, you have a very important responsibility -- to anyone whose interests might be affected by the eventual outcome -- to follow certain logical, analytical procedures. Otherwise, it's dangerously easy to start tinkering with things that may not need to be fixed -- and that's a course that can all too easily lead to mischief.

What are those procedures? At the very outset, I think you must determine whether there really is a problem -- and, if there is, what it consists of and why it has developed. The next logical step is to consider what solutions might be possible and practicable. Depending on the nature and scope of the problem, some kind of educational effort might be indicated. Or voluntary action by those closest to the problem might be appropriate. Or, as a last resort, it may indeed be necessary to consider possible legislative remedies.

#### WHAT THE PUBLIC THINKS

But with respect to the ongoing dialogue on improving corporate governance and accountability, very little of that analysis has been performed. And it seems to me that we need to examine why this has become, in some people's minds, the issue of the '80s. Why is there agitation for government to intervene in the internal affairs

of U.S. corporations? Are we dealing only with overzealous reformers -- or has the issue arisen, in part, because of public disappointment with corporate performance?

There have been plenty of signs of ambiguity in current public attitudes toward many aspects of American life, including business. During 1980, the New York Stock Exchange commissioned a leading polling organization to conduct two opinion polls on public perceptions of the economy. And in terms of how Americans view both government and business today, the results were both disturbing and instructive.

Back in April, for example, the vast majority of respondents to our first poll said the national economy was undergoing a fundamental crisis. Forty-seven per cent blamed poor government leadership and too much government interference in business for the economic decline that was adversely affecting their lives -- while 25% cited "corporate greed" and poor corporate management as the chief reasons. But while 44% said they thought less government regulation would help solve our economic problems, 52% also thought "corporate power" should be curbed.

By mid-November, after the election results were in, the public mood was in some ways more optimistic, but the ambiguous attitudes toward business and government remained. For example, 44% of the respondents still said that government regulation of business should be cut. But at the same time, 42% said they wanted the new President to try to decrease corporate power.

"SOMETHING OUGHT TO BE DONE ABOUT IT"

My own feeling is that Americans essentially admire the economic system that has made this country a land of great abundance. But they are confused and frustrated by what appears to many of them to be a pervasive failure in some areas. And this is often aggravated by the experiences of daily living.

We've all heard the litany of criticisms that people level at corporations today.

For example: "Corporations have too much power -- more power than the government."

Or: "Business increasingly tends to focus on the short-run, to maximize profits in the next quarter and the current year -- at the expense of investing in the future and trying to build a healthy, economically viable business for the longer term."

There are others: "Business cares only about profits and is insensitive to the wishes of customers, to the well-being of the community, and to the needs of society."

"Too many of our products are simply less reliable than imported products. American business doesn't care about quality anymore."

"Compensation is getting out of hand. Executives get paid too much for mediocre performance."

We've all heard those complaints -- and others. Perhaps it's natural to bristle when they are aimed at Corporate America -- to dismiss them as invalid and not worth dealing with. Natural, per-

haps, but very dangerous! Perceptions are very real to those who hold them. And perceptions strongly influence behavior.

Public perceptions of Corporate America today make it very clear that action is urgently needed -- action to change perceptions that may be incorrect; and action to correct the reality if a critical perception has merit.

One reason that corporate governance and accountability may well become a still more serious issue is that many Americans, frustrated by their daily experiences in the marketplace, are beginning to say, "something ought to be done about it." And who is listening? Corporate boards and managers? Or Congress? The public clearly is confused about whether government or business can provide the best solutions. Remember, 44% thought less government regulation would help solve our economic problems -- but 42% also thought that "corporate power" needs to be curbed.

How is business leadership responding to the challenge of public attitudes? I was recently startled by one example:

I believe many of you attended the National Conference on Corporate Governance and Accountability, in Williamsburg, Virginia, that the New York Stock Exchange co-sponsored with the American Bar Association and the American Law Institute last March. Shortly afterwards, I happened to meet the chief executive officer of a listed company that, for obvious reasons, will remain unidentified. I mentioned that we were pleased that two of his associates had been at Williamsburg, and he said they thought it had been a very useful conference. They had reported back to him, with apparent

relief, that there was nothing to worry about, because the general feeling at Williamsburg seemed to have been that Congress was unlikely to get around to passing any legislation for at least another three years!

If that reaction to critical public attitudes toward business is at all common, then much work obviously needs to be done. I certainly hope those people are unique; because if they aren't, Congress will find a lot of support --from constituents who think that "something ought to be done"-- for the kind of legislation that could bring government right into the corporate conference and board rooms. And when you consider government's managerial track record, that prospect doesn't offer much cause for rejoicing.

#### A HIGHER QUALITY OF LIFE

Fortunately, there is a second option. I suggested earlier that the first step is to determine whether there is a problem -- and, if there is, to define its nature and scope. And it seems to me that when 42% of the public thinks "corporate power" should be curbed, there is indeed a problem. And that problem demands, first and foremost, high-priority attention, creative thought and analysis, and intensive, responsive action from the nation's business leaders.

During the past few years, much of the discussion of corporate governance has focused on such matters as the organization and composition of boards of directors, the qualifications of directors and the information available to them, the board agenda, the conduct of board meetings, and so on. But while these matters are obviously

important, they do not represent the fundamental issue facing corporate leadership. The fundamental issue centers on how business leaders perceive the role of private enterprise in our mixed-type of economic system, and how they perceive the nature of the corporation's role -- in terms of accountability and responsibility.

In our form of society, public opinion ultimately determines public policy and legislative behavior. What can we learn, then, from current public attitudes, existing laws, and proposed legislation and trends? One major thread that seems to run through the skein of public attitudes toward business is the desire for "quality": Quality of environment; quality of products and services; quality of physical working conditions; and quality of work life -- that is, the desire of working people to command greater respect and recognition, and an opportunity to participate in developing better work methods and arrangements in the work place.

In short, if business is to fulfill what an increasing number of Americans regard as its proper role in our society, business leaders must recognize that the individual is more than merely an economic entity, that economic benefits alone will not satisfy people's hopes and aspirations. People want a higher quality of life.

The preface to the 1976 Report on Critical Choices for Americans made this very perceptive observation:

"Concern for the quality of life for all Americans has reached a new level of awareness in this country. The comfortable belief has all but disappeared that with enough legislation and enough money, quality could become a reality for everyone. Americans, and particularly young

people, are looking beyond the 'standard of living' as the measurement of quality -- they are searching for new meaning, new self-realization and new purpose in their lives.

"There is no GNP for quality of life, for individuals or for a society. Quality in one person's life can be, and often is, meaningless in another's. While we can and do measure the objective areas of quality of life --per capita income, level of education, employment status, health care, housing-- the subjective elements of quality of life --the values, the attitudes, the philosophies by which we perceive quality-- are much more elusive. We pursue it in very different ways."

The need to understand and fulfill this enlarged and pervasive concept of accountability and responsibility poses an immensely difficult --some might say, impossible-- challenge to the corporate world. And, of course, any effort to define the corporate role raises the question of the appropriate role of government.

Government is, clearly, responsible for establishing and enforcing necessary laws and regulations. But although this is not adequately recognized, government is equally responsible for providing a total environment in which the private sector can maximize its contribution to the economic strength of our nation and the quality of life for all Americans.

In short, government and private enterprise have a shared responsibility to produce sustainable, real economic growth, each playing its appropriate role and working together to help improve the quality of life for our people.

#### ACCOUNTABLE TO WHOM?

And in this context, we need to ask: To whom is the corporation accountable? We can tick off seven constituencies very briefly:

A corporation is, of course, accountable to government, for complying with tax and other laws bearing on its activities.

A corporation is certainly accountable to its shareholders, for managing its assets and operations efficiently, and for retaining and distributing profits responsibly. Without adequate profits, the corporation cannot possibly meet its responsibilities to its other constituents.

A corporation is also accountable to its employees, for adhering to fair and effective management practices and providing satisfactory working conditions, fair pay and benefits.

A corporation is surely accountable to its customers, for fulfilling their demands for well-made products and useful services at reasonable prices.

A corporation is also accountable to its suppliers and others with whom it does business, in terms of fair treatment and prices.

A corporation is accountable to the community in which it operates, for being a responsible tax-paying citizen and participant in activities that contribute to the general well-being of that community.

And, finally, a corporation is accountable to the general public which expects some benefits to flow from the mere fact of the existence of the corporate form in our society.

Obviously, then, corporate executives and directors must not only recognize these varied claims on a company's performance, but

they must find ways for the company to balance them fairly and to respond to them in a responsible manner. And in making fundamental decisions about managing the business, they must also balance such considerations as the desire to maximize short-term profits against equally compelling long-term considerations of building for the future and assuring stable, steady and manageable growth.

How well or how clumsily a corporation performs these delicate, but essential, balancing acts inevitably builds the perceptions of its various constituents as to how well it is being managed. And it is when those perceptions start to turn sour that customers, shareholders and employees are likely to start rethinking their own allegiances -- and when government is likely to start listening sympathetically to complaints.

#### THE ROLE OF THE STOCK EXCHANGE

Logically, this would suggest that corporate executives and directors have always had a fundamental responsibility to themselves to manage their companies as efficiently as they can. But even leaving aside the normal complement of rotten apples that will show up in any barrel, that has not always been the case.

The New York Stock Exchange has a long history of encouraging and, in some instances, requiring its listed companies to recognize and honor their responsibilities to key constituents -- at least in those areas in which it has felt competent to provide useful guidance. As early as 1899, the Exchange began requiring corporations -- as a condition of having their shares listed for trading -- to comply with a specific code of performance. To be sure, those first

listing agreements dealt chiefly with mechanical necessities of the marketplace -- but they did include the then-novel concept that listed companies should furnish relatively simple periodic financial reports to their shareholders.

Companies in those days were reluctant --and, in some instances, downright hostile-- when it came to disclosing information about their financial circumstances. But by 1909, growing public demand for more detailed financial reporting prompted the Exchange to require all listed companies to distribute annual reports to shareholders. In 1928, the Exchange began urging listed companies to have their annual financial statements prepared from figures audited by a certified public accountant -- an innovation that, inadvertently, may have been one of the most massive exercises in job creation in the nation's history.

In those early days, the Exchange's pioneering efforts to encourage even a modest measure of corporate democracy were often condemned as impertinent, meddlesome, frivolous -- and worse. But that was before most of the Federal regulatory agencies had come into existence, and before Congress began actively concerning itself with the protection of investors' interests.

Since then, the listing agreement has expanded to cover many other aspects of corporate performance -- including, for example, proxy notification requirements, timely disclosure of corporate news that might materially affect investment decisions, disclosure of quarterly earnings, and so on. All of these requirements, of course, are in addition to the basic standards with respect to de-

monstrated earning power, assets, and market value and distribution of outstanding shares of common stock, which the Exchange uses to measure a company's eligibility for initial and continued listing.

Today, when we take for granted the public's right to know what's going on, one of the key questions facing us is: What else can and should be done to help assure that the public has ready access to the financial and other pertinent information that investors need to make informed decisions about buying, selling or holding shares of publicly owned corporations? But just as important, we must also develop a better understanding of how to distinguish between responsible corporate accountability and communications, and Federal requirements that might very easily do much more harm than good.

#### CONTRIBUTIONS OF THE LEGAL PROFESSION

And when I say, "we," I do not mean to limit responsibility to the legislators and regulators who have the power to devise new concepts of corporate accountability and require the corporate community to accept them. I would include the corporate community itself, since its leaders have the ability to head off an excess of legislative or regulatory zeal, by seeking out areas in which constructive improvements can be made -- and by taking responsible voluntary initiatives to make them.

In fact, the corporate community has an impressive record of accomplishment in this area in which, as you are all certainly aware, your profession has played a very important counseling role.

For example, recent amendments to the Model Business Corporation Act and the Corporate Director's Guidebook, developed by the Corporate Laws Committee of the Business Law Section of the American Bar Association, represent an important force for deepening directors' perceptions of their responsibilities.

The American Law Institute's project on corporate governance and responsibility is another important contribution. It will draw heavily on the knowledge and expertise of business executives, members of the bar, and the judiciary in assembling the knowledge base needed to analyze the vast body of existing law dealing with internal corporate structure and accountability, and to make recommendations for improving the mechanisms of corporate accountability.

#### NYSE AUDIT COMMITTEE POLICY

The New York Stock Exchange has not remained on the sidelines in this ongoing dialogue. Since mid-1978, our Audit Committee Policy --which was developed with very active and constructive assistance from our listed company constituents-- requires each listed company to have an Audit Committee comprised "...solely of directors [who are] independent of management and free from any relationships that, in the opinion of its board of directors, would interfere with the exercise of independent judgment as a committee member...." This policy provides some guidelines for making appropriate judgments. However, it recognizes that the board itself should be responsible for evaluating the qualities, characteristics and relationships which define a director's independence. And this is in keeping with our firm belief that the corporation should be free to exercise its best discretion in selecting as directors the men and

women it believes can make the most effective and responsible contributions to corporate excellence.

#### VOLUNTARY CORPORATE ACTION

While the new Exchange and recent SEC requirements triggered considerable discussion and debate before their final adoption, they were perhaps less dramatically innovative than either organization would have liked to believe. The fact is that many U.S. corporations had been voluntarily implementing important changes in the structure and composition of their boards since the 1960s, and that trend was still gaining momentum.

But in 1978, no one really had a clear idea of the scope or character of those voluntary innovations. To find out, the Exchange and the American Society of Corporate Secretaries cooperatively undertook a Survey of Corporate Boards, Structure and Composition. Nearly 1,000 companies --almost 60% of the ASCS national membership-- responded to a detailed questionnaire. And the findings were rather startling: Most of the responding companies reported that they had Audit Committees; a large majority had Compensation Committees; and quite a few had Nominating Committees. And in most cases, those committees were restricted to, or had majorities of, non-management directors.

#### INDEPENDENT DIRECTOR MAJORITIES

In late 1980, the Exchange staff reviewed the most recent proxy statements of some 1420 listed companies to determine both the extent to which the creation of these key committees has gained additional acceptance, and the nature of their composition. The results are very instructive.

In compliance with the Exchange's Audit Committee Policy, all 1420 companies had Audit Committees composed exclusively of independent directors.

1195 of the 1420 companies included in the review --84%-- had voluntarily established Compensation Committees. More than 1100 had at least a majority of independent directors, and about 800 were entirely composed of independent directors.

The number of listed companies that had established Nominating Committees had also increased substantially since 1978, although the Nominating Committee concept remains an untried innovation for many. 528 out of 1420 --37%-- had such committees. More than 90% of them had independent director majorities, and about half were composed entirely of independent directors.

These figures leave no doubt that the private sector is actively pursuing responsible ways of enhancing corporate accountability -- without any action from Congress. Nevertheless, Congress has begun considering legislation. You are familiar with the status and outlook for those efforts, and there is no need for me to summarize them.

#### THE CHALLENGE TO CORPORATE AMERICA

But I do want to summarize four conclusions to which any reasonable approach to the issue of corporate governance and accountability inevitably leads us:

First, Corporate America has voluntarily made considerable progress in recent years on the governance issues that have attracted the most attention.

Second, corporate governance will become an increasingly prominent issue in the '80s. This will demand not only creative ideas, but innovative action as well, from corporate boards and management.

Third, public perceptions and public opinion will ultimately determine the nature and scope of government intervention in corporate affairs.

Inevitably, then, the fundamental issue is not how to improve the mechanics of corporate governance -- but how to develop a logical, coherent and practicable philosophy of corporate accountability and responsibility.

Thus, corporate directors and management face the immense challenge of developing a philosophical base --and a practical value system-- as a foundation for corporate decision-making. Here, too, however, we can find at least some signs of recent progress.

More and more corporations are establishing Codes of Conduct. To be sure, some of those codes are perhaps too limited in concept; some seem merely to be lofty phrases that lack a genuine commitment on the part of directors and management. But others do signify a genuine determination to establish values and guidelines for directing and managing the corporation and for strengthening responsible corporate decision-making in ways that merit favorable public support.

Clearly, both the corporate community and government must develop a better and broader understanding of their respective roles and their common responsibility to work together to help achieve the societal goals shared by all Americans. Any continuing significant gap between

public expectations and what "the system" can and does deliver will pose a serious threat not only to the private sector in this country, but to our form of government. We must recognize, too, that if legislators, regulators and the corporate community are to develop a really constructive relationship within the framework of our private enterprise system, the corporate world must provide stronger, more effective leadership. Only then will it be possible to reach intelligent conclusions about what corporate accountability problems may really exist, which public perceptions may, in fact, be erroneous -- and what kind of action may be appropriate.

The legal profession has been in the forefront of efforts to identify corporate governance issues and stimulate intelligent discussion of their nature and implications. Corporate legal counsel occupy a position in the management hierarchy that is both important and unique, in that you can help directors and management focus on the immense challenge facing them: The challenge of rethinking the proper role of the corporation --in terms of its fundamental responsibilities and accountability-- in our society today.

I am confident that you will continue to bring to this urgent task the same high level of dedication and professionalism that have always characterized your efforts -- and that all of us outside the bar admire so greatly.

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