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(202) 272-2650

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NATIONAL CONFERENCE ON CORPORATE GOVERNANCE AND ACCOUNTABILITY IN THE 1980's

Remarks of

HAROLD M. WILLIAMS, CHAIRMAN
SECURITIES AND EXCHANGE COMMISSION

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I am pleased to have the opportunity to share a few brief thoughts on the subject of corporate governance and accountability with this distinguished audience. Since becoming Chairman of the Securities and Exchange Commission almost three years ago, and indeed well before that time, I have spoken out frequently on the accountability of corporate power and on my concept of the ideal corporate board, the sociology of the board room and the importance of improving corporate accountability. I believe strongly that the general topic -- the legitimacy of the private corporation as the focal point of our economy -- is one of the most significant and far-reaching issues being debated in our society today. For that reason, conferences such as this are particularly important.

I do not intend in these observations to urge any particular approach or philosophy to the problem of strengthening both the reality and the public perception of corporate accountability. Instead, I intend to confine my remarks to a more limited point -- the complexity of the system which we are examining. Effective corporate accountability is not merely a question of the identity of individual directors, the structure of particular boards, or the acts of specific corporations. Rather, it is an objective which can only be approached with due regard for the environment -- the interrelationship of people and institutions -- in which it grows. Managers, directors, auditors, lawyers, government, communities, and the public-at-large all affect, and are affected by, that environment. It is important that, in focusing on each component, we not lose sight of its relationship to the whole.

There is a natural tendency to overlook this kind of systems approach in examining a complex problem. Ours is a legally-oriented society, and the systems approach does not lend itself to traditional legal analysis or to resolution by governmental intervention. Therefore, it is not surprising that most legislative models on corporate governance center not on the dynamics of the corporate system but on individual questions which fit more comfortably into a legal framework, such as the independence of directors. To the legal mind, independence is, after all, a relatively comprehensible concept that is susceptible to statutory articulation. Nonetheless, there is only a limited efficacy to isolating a single factor in such a complex of relationships. And, as we have learned over recent years in dealing with other complex systems, such as the environment or the economy -- the negative consequences of disturbing such a system without understanding all the ramifications of our actions -- the waves we make -- can be both severe and irreversible.

In this regard, several thoughts need to be kept in mind. One is that we should take care not to damage the vitality of such a crucial institution in the name of improving it -- particularly when there is no adequate alternative for creating real wealth, new goods and services, and increased employment opportunity. The modern corporation is the most effective and successful economic institution ever devised. The wealth of our society flows primarily from the corporation and its accomplishments and, in turn, the personal and political liberties which we cherish, in large measure, go hand in hand with our economic freedom and are sustained by that corporate-generated social wealth.

In addition, the corporate form has proven to be one of the most flexible and adaptable economic tools ever devised. It has been unique as an institution in its ability, over time, to perpetuate creativity and managerial efficiency in an environment which, during the last 100 years of the corporation's rise to economic predominance, has undergone unprecedented technological and social changes. This apparent ability to defy the natural tendency of the creative to erode into the mediocre has been achieved because the corporate system is based on a form of economic meritocracy. While there are inevitable exceptions and setbacks, over the long pull the corporate system depends upon the principle that the successful concept, product or person, which can contribute to the goals of the enterprise and serve a consumer need, will be recognized and rewarded. On a more abstract level, the corporation itself will flourish or eventually fail largely according to the skills and ingenuity of its management and its ability to serve society better than its competition.

What elements in the corporate form have led to this success? It can be credibly argued that the general absence of structural requirements -- a remarkable situation given the existing scope of corporate power in our society -- has allowed corporations to adjust so successfully to the changing features of the economic and social landscape. If this is true, by mandating specific structure or process, we may unwittingly deprive corporations of the flexibility to adapt to future societal and economic conditions. On the other hand, however, Americans have a deep-rooted sense that power -- no matter how beneficent its exercise -- needs to be accountable to society-at-large. And, we have witnessed in the past decade notable and well-publicized instances in which corporate power has been abused to the detriment of the public. As a result, calls for legislative constraints on the corporate decisionmaking process have a deep appeal.

It is this dilemma -- the undeniable economic success of the corporation and the role which flexibility in governance mechanisms has played in that success, on one side, and on the other, the sense that this flexibility ought to be restrained -- which makes discussion of corporate accountability challenging and difficult for those who are genuinely sensitive to both the importance of the national economic health and to the significance of public confidence in the legitimacy of corporate power. I have no easy answers to this problem. I do, however, want to underscore some of the dynamics that shape the operations of the contemporary corporation in order to assure that those of us who advocate change appreciate the delicate and highly interrelated fabric with which we are working.

The most conspicuous actor on this stage is the corporate manager. 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 profitablity 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.

The second major actor within the corporate scheme is the board of directors. The board's ability to function effectively is related to its competency and its independence-in-fact. While competency is a relatively well-understood term, the concept of independence appears to be misunderstood by many. A board's contribution to corporate accountability depends ultimately not on whether there is some defined nominal degree of independence from management, i.e., structural independence, but rather on whether the board is independent-in-fact -- an operational independence -- that means that the board is not dominated by, or subservient to, management. While there is some correlation between the nominal independence of a director and operational independence, to focus primarily on the former is to miss the substance.

To be independent-in-fact, the director must have, among other things, a continuing free and full access to all material information regarding the corporation's activities. Only then can the truly independent director be capable of an objective assessment of managerial performance -- in both its short-term and long-term contexts. Yet, these important characteristics -- which involve personal dynamics -- do not inevitably result from a board's having a particular structural character.

True, the absence of structural impediments, such as those I have addressed in my talks, remove a barrier to improved corporate accountability. Indeed, the burden of justifying these apparent barriers falls on the corporate board that permits their existence. But, on the other hand, it would be erroneous to assume that removal of one particular type of impediment necessarily means that the corporate governance question is resolved. Focusing solely on the structure of the board gives an inappropriate presumption of propriety -- a legal imprimatur -- to a decision by a board which may have only one of many traits necessary to effectively function.

It is also not productive to focus on the dynamics of the board without considering other associated institutions. For example, to the extent that the board's access to complete and credible information is critical to good corporate governance, audit committees and effective internal corporate controls may be crucial to the success or failure of the accountability structure. It also is dependent on a strong, effective and well-disciplined independent accounting profession. In turn, the resolution of issues relating to appropriate accounting principles, professional quality control, and professional disciplinary procedures cannot be divorced from an examination of corporate accountability.

Similarly, in a complex society, corporate counsel -- both inside counsel and the private bar -- plays an important role in establishing effective corporate accountability. Lawyers are, in their many diverse roles, architects -- consciously or unconsciously -- of the accountability mechanisms in our corporate structure. Accordingly, if the private sector tends at times to be expedient, lacking in vision in assessing the future and what it holds, and reactive in attempting to meet the demands and expectations to which it must respond, its counsel must share in the responsibility for the consequences. Conversely, the corporate lawyer, in his role as counselor and adviser, can play a significant positive role. If lawyers choose to bring to bear the broader vision with which many are well-equipped, they can help to preserve the flexibility and vigor of the corporate system which have served our economy so well.

Additionally, the investment community -- investors, financial analysts and financial institutions -- provide an important corporate monitoring function. Their task is to responsibly and rationally determine the capital allocation system by which marketplace discipline awards the innovative and abandons the inefficient -- the system of economic meritocracy that is necessary to the continual rejuvenation of the private sector.

Finally, any study of the state of corporate accountability must recognize the private sector's interrelationship with the government. While, at times, governmental action has proven beneficial, there are major risks that arise whenever government intervention is invoked. Particularly in its legislative function, the government is not a subtle intervenor. As the most powerful force in society, and the only one that can impose its will, it almost always can get its way by sheer coercive force. Therefore, it institutionally never had to, and never did, develop a sensitivity to the subtleties of interpersonal and interinstitutional dynamics in other than a political context. And, that means it generally acts without awareness of the effect of its actions on such sociological relationships. Moreover, by necessity, government typically deals in generalities in its own decisionmaking process. Those who fall within the parameters of a law's jurisdiction must conform to a uniform standard, regardless of the economic consequencs or any argument that conformity is not necessary. I, for one, am skeptical that this kind of "regulation" is appropriate to the extraordinarily complex and diverse decisions that are encompassed by the corporate decisionmaking and accountability process in hundreds and, indeed, thousands of companies around the country. I believe that we must recognize the limits of what government can do well. And, we must appreciate the societal risks in subjecting effectively-functioning institutions to laws which are outside these bounds.

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As I pointed out a few moments ago, corporations have done an exceptional job of remaining dynamic institutions.

Indeed, the record, particularly in recent years, of the corporate community's increasing sensitivity and concern over its accountability mechanisms is an illustration of responsiveness which characterizes private enterprise. Change has been incremental as a result of experience -- often too slowly and too late and including some absolute failures -- and, hopefully, change has been achieved without destroying the institution it is intended to improve. As a Nation we cannot afford to risk the effective functioning of our predominate economic institution in the name of some speculative benefit. Thus, the most valuable contributions that may be made by gatherings such as this one are: to identify those whose responsible behavior is vital to an effectively-functioning corporate community in society; to better define their duties; and to assess how progress can best be accelerated.