

# SEC Historical Society

## Corporate Governance in the New Century 15th Annual Meeting Program

June 5, 2014

**W. Hardy Callcott:** Good afternoon. Welcome to the 2014 Annual Meeting Program of the SEC Historical Society. I'm Hardy Callcott of Sidley Austin, and I am, through a fit of absent-mindedness of our Board, the President of the Society for this year.

On behalf of my fellow trustees, it's my pleasure to welcome you all here today, and those who are watching live on the [www.sechistorical.org](http://www.sechistorical.org) website. For nearly a decade, the SEC Historical Society has presented this Annual Meeting Program in conjunction with the anniversary of the founding of the SEC. Today, it's my honor, as a proud SEC alum, to congratulate the SEC on the eve of the 80th anniversary of its founding on June 6, 1934. On the SEC's 25th anniversary, then U.S. Supreme Court Justice William O. Douglas, who had been the SEC's third Chairman, said "We had an able, earnest and dedicated group of people administering the acts. We had youth and idealism on our side." This is as true today as it was when Justice Douglas said that in 1959, when I was younger and I was at the SEC myself.

I should note that the Society is independent and separate from the SEC and receives no funding from the public sector. We're grateful to the SEC for its ongoing hospitality in sharing this space for our annual meeting. As I begin my tenure as President of the Board I'd like to acknowledge my fellow officers: Linda Thomsen of Davis Polk, Cindy Fornelli of the Center for Audit Quality, Bruce Bennett of Covington & Burling, Lisa Beth Lentini of Carlson Wagonlit Travel, David Lynn of Morrison and Foerster, and Daniel Goelzer of Baker & MacKenzie. I'd also like to welcome five new trustees to the Board: Mark Cahn of WilmerHale, Thomas Gorman of Dorsey & Whitney, David Harms of Sullivan & Cromwell, Philip Khinda of Steptoe & Johnson, as well as Dan Goelzer, who is re-joining us as a trustee.

We're very proud of our unique virtual museum and archive of the history of financial regulation at [www.sechistorical.org](http://www.sechistorical.org), which celebrated its 12<sup>th</sup> anniversary earlier this month. We take seriously our responsibility to keep the museum independent and objective and to ensure that it remains free and accessible at all times. We couldn't build the museum and serve the current average of 4,400 visitors a day without the generous support of so many of you. We encourage you to read our 2013 Annual Report which is available online and which demonstrates how we steward the gifts that we receive. We're pleased to report that more than 82% of our gifts go directly to the virtual museum and archive.

I'd like to thank the generosity of the Center for Audit Quality for sponsoring the Gallery on corporate governance for our museum, for which today's program will be an important part. The subject of corporate governance, which encompasses both those who regulate and those who are

regulated, is a uniquely good fit for our museum and we look forward to its opening in December. This year, the Museum Committee of the Board is offering a writing award on any area of corporate governance, which will be added to the museum collection and which will be linked to the Gallery on Corporate Governance. Now I'd like to introduce Carla Rosati, our Executive Director and founder of the virtual museum, to present the writing award for this year.

**Carla Rosati:** Two years ago, David Martin, then Vice President-Museum on our Board of Trustees, encouraged us to add a writing award to the arsenal of our virtual museum and archive of the history of financial regulation. Thanks to the generosity of the Center for Audit Quality and their willingness to add such an award as part of their sponsorship of the Gallery on corporate governance, the writing award competition launched last summer. We invited all museum visitors to submit original essays on any subject on corporate governance and utilizing one or more museum materials to be submitted by the end of last year. Following review by the Society's Museum Committee, and by Dr. Kenneth Durr, curator of the Center for Audit Quality Gallery, we are pleased to present the 2014 writing award to John Okray for his essay, "Mutual Fund Boards on Governance: Do as I Say Not as I Do". Mr. Okray is Deputy General Counsel and Assistant Secretary of American Beacon Advisors Incorporated, resident in the Fort Worth area. He is also chair of the Corporate and Association Counsel Division of the Federal Bar Association nationwide. His essay is now a permanent part of the museum collection and will be linked within the Center for Audit Quality Gallery, which will open in our virtual museum and archive on December 1st. John, congratulations.

It is now my privilege to introduce the Honorable Daniel Gallagher, SEC Commissioner, to make remarks on behalf of the US Securities and Exchange Commission.

**Daniel Gallagher:** Thank you very much, Carla, and thank you for all the work you for the Historical Society. You do a great job. And if only I could give remarks on behalf of the Securities and Exchange Commission. Probably a good time to give you the disclaimer that my remarks reflect my own views, not necessarily, unfortunately, the views of the Commission or my colleagues on the Commission.

The SEC Historical Society plays an important role in helping maintain a collective memory of the SEC's triumphs and failures so that the current and future generations of Commissioners and staff can learn from their predecessors. I'm pleased to have the opportunity to share a few brief thoughts with you today at the Historical Society's annual meeting. Today's event commemorates the 80<sup>th</sup> anniversary of the creation of the SEC and the Securities and Exchange Act of 1934. As I'm sure you're all aware, only a few days ago, it was the 81<sup>st</sup> anniversary of the Securities Act of 1933, an event also worthy of celebration. One of the nice things about speaking to a Historical Society event is that you don't have to provide a history lesson as background.

With that in mind, I'd like to share a few thoughts related to the '33 Act which embodies the idea that requiring the disclosure of material information to investors promotes confidence in the markets. At the time of its passage, of course, investors' confidence was still badly shaken by the 1929 stock market crash and ensuing Great Depression. Initially, in the dark days before the creation of the SEC, the authority to administer the new disclosure regime was given to the Federal Trade Commission. According to the Historical Society's museum, the FTC's initial

approach to implementing the '33 Act, and I quote, "may have let principles get in the way of practicality." Which raises the interesting question, and I quote again, "Even if sunlight could clean up the markets, could too much sunlight, by making it difficult for corporations to issue securities, impede recovery?" The Historical Society further indicates that businesses, at the time, believed that too much sunlight was indeed harmful and reacted to the FTC's overzealous use of its new powers by lobbying to shape the then-draft Securities and Exchange Act. Their goal was to create a new regulator for the exchanges with the authority to administer the '33 Act as well, and that, of course, came to fruition in the '34 Act. And so, the SEC was born.

Eighty years later, however, the problems arising from excessive disclosure remain. In his SEC Speaks speech last year, my friend and former colleague, and Jill's soon to be colleague, Troy Paredes, expressed his concern that the expansion of mandatory disclosure requirements may lead to what he called "information overload", not just in volume, but also in the complexity of the presentation. In a speech later in the year, I reiterated Commissioner Paredes' concern. I believe that, just as was the case eighty years ago, the problems arising from too much sunshine impeding economic recovery are among the most pressing issues that we face as an agency. The Commission's success has been built on requiring disclosure of material information, that is, information with a substantial likelihood that a reasonable investor would consider it significant. Today, the core of that approach is under attack. We've seen an increasing encroachment of Congressionally-mandated corporate governance-related disclosure requirements beginning with the Sarbanes-Oxley Act, and accelerating significantly with Dodd Frank's say on pay, pay ratio, compensation claw back, pay for performance and hedging disclosure requirements. These forays into corporate governance, an area traditionally and better regulated by the states, distract us from our core purpose. Worse, other legislative mandates utterly devoid of any connection to investor protection, such as the Dodd Frank Title 15 trifecta of mine safety, extractive resources and conflict minerals disclosures, have driven us still further afield.

Meanwhile, as I noted earlier this year, activist investors and corporate gadflies have hijacked the shareholder proposal system to advance idiosyncratic and often political disclosures that are irrelevant to, or even contrary to, the interest of the average investor. And yes, I continue to believe this, despite the crying and wailing that followed my speech. The activities of these special interests are aided and abetted by proxy advisory firms that are all too willing to recommend votes in favor of these proposals. At the same time, the Commission has been subjected to a barrage of pressure to attempt to restrict corporations' exercise of their First Amendment rights to political speech. Academics through rulemaking petitions and members of Congress through letters, as well as the ever courageous unidentified persons pushing hit pieces into so-called media, have been seeking to compel the Commission to regulate indirectly through disclosure where direct restrictions have been stricken down as unconstitutional.

Finally, I'm seeing a growing trend of special interests pushing companies to provide sustainability and wholly other non-financial disclosures. A company can, of course, agree to provide such disclosures based on the company's own assessment of the merits and through the company's own information dissemination mechanisms, for example, on its Web site. But I worry that it is only a matter of time before the not too subtle, so called "voluntary," push for disclosures morphs into an express effort to mandate these disclosures by embedding them as new requirements in our rulebook. The majority of these disclosures are simply not material to a

reasonable investor. Rather, they are being mandated in order to advance social goals by naming and shaming corporations. Other disclosures are being advanced by groups that take the paternalistic view that, if only the investors knew what was best for them, they would be demanding these disclosures. I'm honestly not sure which is worse. Company disclosure documents are being cluttered with non-material information that can drown out or obscure the information that is at the core of a reasonable investor's investment decision. The Commission is not spending nearly enough time making sure that our rules elicit focused, meaningful disclosures of material information. Although there have been incremental improvements over the years, with another such effort currently under way, thank you very much Keith, the last comprehensive overhaul of our disclosure rules was in the early 1980's with the integration of disclosures under the '33 and '34 Acts.

I believe the next few years will be critical for the SEC, in particular for our disclosure-based approach to regulation that has helped make our capital markets the envy of the world. Will we let our disclosure regime be crippled by the pursuit of special interest goals, or can we reinvigorate our core mission and put this agency on a path that will help it survive and thrive for another eighty years? It's my sincere hope that when the SEC Historical Society meets to commemorate the 160th anniversary of the '33 Act their answer to these questions will be "Yes, we could and did." Thank you again for the opportunity to speak to you today and I hope you enjoy the rest of today's program. Thank you very much.

**Dr. Kenneth Durr:** Thank you, Commissioner Gallagher, and welcome to Corporate Governance in the New Century. I'm Dr. Kenneth Durr, Executive Vice President at History Associates, Inc. and curator of the Center for Audit Quality Gallery on Corporate Governance, permanently opening in the virtual museum and archive on December 1<sup>st</sup>. The gallery will bring together over five hundred primary materials on such themes as early corporate governance from the late 1700s to the early 1960s; the period of the mid-1960s to 1980 examining the Williams Act, shareholder concerns over corporate social policies, the Penn Central failure and new SEC initiatives; the advancing economy through the early 1990s looking at deregulation, corporate mergers and takeovers, and the impact of institutional investors; and recent governance issues in light of the Sarbanes-Oxley Act and the Dodd-Frank Act.

Today's program -- and I very much hope that it will be a discussion -- will build on the Gallery's look at corporate governance going forward into the 21<sup>st</sup> century. I'm delighted to welcome to the discussion Dr. Jill Fisch, Perry Golkin Professor of Law and the director of the Institute for Law and Economics, University of Pennsylvania Law School; and John Olson, a partner at Gibson Dunn & Crutcher LLP in Washington. Cynthia Fornelli, Executive Director of the Center for Audit Quality, and I should note that Cindy is not participating because the Center for Audit Quality is the sponsor of the gallery; instead she's here in a more important role, representing the public company auditing profession. It's easy to focus on the law and legal issues when addressing corporate governance, but it's important that the Gallery also address governance issues impacting accountants and auditors. Also we have Keith Higgins, Director of the SEC Division of Corporation Finance, and finally Ann Yerger, Executive Director of the Council of Institutional Investors. Thank you for joining me today. Our program will be an interactive one with each presenter opening a discussion area with the others joining in and we'll begin with

Ann, setting a baseline for corporate governance prior to 2002. I think we definitely want to take a look at the rise of institutional investors in that bundle of issues.

**Ann Yerger:** I think what I'll do is start with where we are today because I think one of the more significant trends in the corporate governance space in the past few decades has been the rise of the institutional investor. When CII was founded, now nearly thirty years ago, institutions owned a third of the equities of U.S. companies. Today that's more than 50% and at the largest U.S. companies, that's more than 70%. At the same time, institutional investors have increased their activities in corporate governance and their awareness of corporate governance issues, and I think this is due to a number of factors. First, to the absolute least influence is the fact that they do, in many cases, have a legal obligation to be involved through their proxy voting. I think, secondly, the SEC rules in 2003 that mandated that mutual funds had to disclose their proxy voting practices forced many to sharpen their games in this space, but I think far more importantly, particularly over the last fifteen years, investors large and small have learned that corporate governance can be a very significant risk factor to their investments and to their portfolios and as a result they're much more engaged on these issues. So, I think today the corporate governance community from an investor standpoint is much deeper and larger than it was when CII was founded by a handful of leaders of union and public pension funds. This is a mainstream issue. CII was considered sort of a radical fringe group when it was founded and it still is, but many of the issues and policies that we endorse are now embraced quite widely and embodied in policies endorsed by other organizations such as the Business Roundtable. So, the governance space evolved tremendously. Very quickly, in terms of the issues of interest, I think there's been huge evolution since CII was started. Initially in the 80s, the focus was more on the takeover things - greenmail, poison pills. There was an evolution to the structure of the boards and board committees. Today, I think the focus is front and center on the board itself, the functioning of the board and individual directors, and I don't see that changing for the foreseeable future.

**John Olson:** What was the year that CII was founded, Ann? I'm trying to remember.

**Anne Yerger:** 1985.

**Dr. Kenneth Durr:** John, take us back to that period - the poison pills and some of the other drivers that, perhaps even before that, brought corporate governance into the public language.

**John Olson:** As a securities lawyer and a deal lawyer, I first got into corporate governance, as many of us did, with the voluntary disclosure program that was developed by Stan Sporkin and others at the Division [of Enforcement] in the wake of the Watergate crisis. For the first time, corporate boards and special committees of those boards made up of independent directors took a hard look at practices that were of concern to investors, and I think Stan gets a lot of responsibility for that. Then, late in 1977, the Foreign Corrupt Practices Act was enacted. At this same time, starting in 1977, actually April of that year, Harold Williams, then the SEC Chairman under Jimmy Carter – and I see Amy Goodman in the audience who worked with Harold Williams - began a program of having hearings around the country and looking at what should be done to make corporate directors and managers more responsive to investor interest. It ended up with a report early in 1978, and that was actually filed with a committee of Congress, and these

things are all in the virtual museum. A lot of us started to worry about these corporate governance issues then. Many of us worked on special investigations. I'm sure that Linda [Thomsen] did and I did and others. The result of that is we came into regular contact with independent directors who were dealing with, perhaps, bad judgments by management. And from that, a number of things happened. Some audit committees had independent counsel; I've been independent counsel for the audit committee of one large company for about 25 years. And you had people in the boardroom thinking about process and thinking about what the directors ought to be doing to be sure, not that they are micromanaging things, but that the company is being operated in the best interest of its stakeholders by management. And this goes way back to Berle and Means, but I think in the 70s was when it really picked up. The takeover boom certainly contributed to that, because there was that discipline of the marketplace, and a lot of scholars have said the discipline the marketplace is really important - the fact that you could be subject to a hostile takeover even though somewhat controlled by the Williams Act provisions in the 70s still caused people in boardrooms to think "we are accountable." That's why I asked Ann when CII began, because, I think even before institutional investors, there were other forces at work focusing on governance.

**Dr. Kenneth Durr:** Clearly one of the big themes that we are going to be talking about today is that transition from state law to federal law in corporate governance. And even moving into the 90s, I wonder if there was a sense that state law, and particularly Delaware law, had somehow become inadequate in the area of corporate governance. Is that something, Jill, that you can talk a little bit about?

**Professor Jill Fisch:** It's funny because the academic community has debated this issue and obviously...

**John Olson:** ...still is. As witnessed in our keynote this morning.

**Professor Jill Fisch:** And policymakers, the same thing, and we see in Dodd Frank, which is at least the high point to date of federal regulation of things that we might consider traditionally state law or corporate governance. One of the challenges is that we have had a set of shared responsibility for what we might think of as corporate governance going back to the '33 Act and the '34 Act, because on the one hand you've had federal regulation through disclosure of all of these topics: Who is on the board? What is the background of the directors? What are the qualifications interlocking directorships, independents? Director tenure. All of that you get at through disclosure. Same thing with respect to voting, shareholder voting and the voting of institutional investors and the voting policies and the influence of proxy advisors. That all comes in through federal regulation, but the underlying debate, the substantive question - What is good corporate governance? - is not something that the federal securities statutes speak to and not something that we have traditionally viewed as within the expertise of the SEC. So it's hard to regulate the tools without taking a normative position on the ultimate issue. Should you have greater director independence? Should mutual funds be required to vote their shares and develop voting policies? Is executive pay too high? What do we think of the executive getting 1000 times the pay of the average worker? You cannot really separate out those two questions.

**Dr. Kenneth Durr:** Were the normative issues covered in state law moving through the '90s and into the 2000s?

**John Olson:** Broadly.

**Professor Jill Fisch:** Covered is a tough question. Yes they were. They were through things like fiduciary duties, like questions of what constitutes an effective board investigation. The doctrine of waste with respect to executive compensation, although that is arguably kind of a red herring. But shareholder voting rights are based on or created by state law. So, yes all of that was covered, but in a much less top-down way and in a much less one-size-fits-all way. Whenever you are dealing with a question under state law, you are dealing with it in the context of a particular decision, particular board, a particular company. So it's not these five principles of director independence. It's "Did this board at this time have the necessary independence to behave in an appropriate manner?" It's a very different kind of inquiry.

**Ann Yerger:** May I jump in on this? With a bit of fear since I think I'm the only non-lawyer on the panel, but I will say my observation is that the patchwork system of regulation here in the U.S. with federal and state and self-regulatory organizations is sort of the curse and the blessing of the system. And for investors, opportunistically to be perfectly blunt, it's easier to go federal to mandate changes than it is to try to go state-by-state. So I think that if there is a perception that Delaware may not be stepping up in a way that investors feel is adequate, or it is going to be too difficult to move something state-by-state, then there will be pressure put on a federal level, either on Capitol Hill or at the exchanges. I think the Commissioner touched on that. I don't think that there is any taking the genie out of that particular bottle to be perfectly honest whether the Commission likes it or not. It's an effective way to try to force changes quickly and apply broadly.

**Dr. Kenneth Durr:** And speaking of the genie in the bottle, I think that there were two stoppers to the bottle. The first one being Sarbanes-Oxley. And we know that significant regulatory change comes with crisis and Sarbanes-Oxley followed a crisis. Cynthia, I wonder if you can take us a little bit through some of the issues that were surrounding SOX, especially the audit. Why did we end up with all these audit rules in SOX?

**Cynthia Fornelli:** Going back to something that Commissioner Gallagher said, if you think about the landscape, as you mentioned, there was immense pressure in the system because of the things that you were seeing. Prior to the early 2000s and late 1990s, you had the dotcom bubble, so that was eroding investor confidence. You had the frauds that rocked the corporate world and the regulatory world as well, and pressures by investors and others who saw great declines in the value of their investments. Many well-known, large companies went out of existence. You had CEOs and CFOs going to jail. And again, investor confidence just vastly declined. So I think that there was pressure for Congress to do something and for the SEC to do something. But as you think about moving from state regulation to federal regulation, you also saw the auditing and accounting profession already moving more toward independent regulation and being less reliant on self-regulation. So a lot of the things that Sarbanes-Oxley brought to the table were things that were already being discussed, both within the profession as well as at the Securities and Exchange Commission and in the investor community. So, I think that's why you saw such huge overwhelming support for the Sarbanes-Oxley Act. The Senate approved it 99-0. The House

approved it 423-3. So unlike some of these other "stoppers" as you call them, at the time there was immense support for the Sarbanes-Oxley Act, and in that support to get it implemented very quickly. Again, unlike some of the more recent legislation that has taken a while to implement. But I would dare say looking back, Sarbanes-Oxley was a much simpler piece of legislation than the Jobs Act and the Dodd Frank Act.

**John Olson:** It did change things dramatically for the accounting profession.

**Cynthia Fornelli:** It totally did, in four big areas. You went from self-regulation to having an independent oversight, with the creation of the PCAOB.

**John Olson:** Away from the state regulation.

**Cynthia Fornelli:** Yes, you have the creation of the PCAOB, that not only set standards, but also had an inspection and an enforcement piece. You had the advent of the independent audit committee. So the auditor was no longer being overseen within the corporate structure by company management, but rather by an independent audit committee. You had the separation of the audit from the non-audit services, with only very few permissible non-audit services being allowed. So all of those were drastic changes. Then you had the corporate changes that went with it. You had the CEOs and CFOs certifications.

**John Olson:** Anonymous reporting up the line of financial reporting and controls issues.

**Cynthia Fornelli:** Right, the whistleblowers, the ethics requirements. You had the requirement that companies had to have robust internal controls and then the auditors testing those internal controls, which I know was very controversial, the implementation of 404(b). But we have seen investor confidence improve dramatically since the implementation of Sarbanes-Oxley. So, while I think it was painful and I know this is controversial, I talk to CEOs and CFOs from companies almost daily and when I ask them point-blank, "What do you think about the internal control piece and 404 of Sarbanes-Oxley?," they all will admit that it was very helpful and did change things, and did give investors the confidence that they needed in our marketplace. So net/net, I certainly think that the process of financial reporting in general, and audit quality specifically has vastly improved over the last twelve years.

**Dr. Kenneth Durr:** What were some of those things that the audit profession was anticipating pushing forward previous to Sarbanes-Oxley?

**Cynthia Fornelli:** John you can weigh in as well, but there were already discussions about independence. You had seen a rise of consultancy by some of the accounting firms.

**John Olson:** The SEC had started an independence project well before that and the profession through the AICPA and major firms was very heavily involved in discussions with the SEC at the level of Commissioners and staff, and a lot of that ended up in Sarbanes-Oxley.

**Cynthia Fornelli:** Honestly, there was a difference of opinion, I think, among those in the profession as to some of the independence rules. But a lot of that thinking had been done ahead of time. I have heard it described that Sarbanes-Oxley was pulled off the shelf.

**John Olson:** It was pulled off a lot of shelves including the SEC shelf where Arthur Levitt had already started, with Lynn Turner and with his legal staff, well down the road through listing standards and through the bully pulpit of focusing on independence issues and focusing on getting beyond having self-regulation. He wasn't the author of the PCAOB, but he was very much involved in its creation.

**Cynthia Fornelli:** Right, and there were precursors to the PCAOB that were already in place.

**John Olson:** There was an industry group and which various people served on that conducted peer reviews. So like everything, these are evolutions. Sending notes with Jill over here, we were trying to remember the year that Rule 14(a)(8), under the 1934 Act, was first adopted. I think it was in the '30s or '40s. That responded to an issue.

**Audience member:** 1942.

**John Olson:** Thank you very much. The voice of experience. So, 1942, about the same time as Rule 10(b)(5) and, if you think about it, that was an SEC incursion into what was formerly a state issue. What you could say and what you could put before a meeting was a matter of state law and it is still a matter of state law. But what you can put in a proxy, including what you can propose for consideration at the meeting by virtue of it being in the proxy, has been a matter of federal law under 14(a)(8) for a long time with respect to shareholder proposals. It's just that it has become much more used recently.

**Keith Higgins:** Right, but I don't think that 14(a)(8) permitted proposals that were not permissible under state law. What it did recognize to regulate the proxy system is that you did not have annual meetings anymore where all of the shareholders showed up in the meeting and everybody voted by voice vote or by written ballot. You had the de-materialization of securities and trading.

**John Olson:** At a widely held, publicly traded company there's no way for people all to show save for the proxy process and if they have the right of state law to present something, then how do you provide for that?

**Keith Higgins:** It allowed, I think probably on the governance issues shareholders actually to exercise the governance rights that state law gave them.

**John Olson:** You and your staff are now stuck making decisions about what goes in and what doesn't.

**Keith Higgins:** That is true.

**Professor Jill Fisch:** It wasn't like there was some readily consultable state law that answered the question of what is permissible in a proxy statement. Your office was making all of those decisions. And if you go back to the early use of Rule 14(a)(8), people like John and Lewis Gilbert, they were poking about things like auditor independence and disclosure of audit report and making those governance issues years before Sarbanes-Oxley.

**Dr. Kenneth Durr:** Terrific! And we're going to talk about the proxy process.

**John Olson:** Shows the importance of the museum!

**Dr. Kenneth Durr:** We're going to get back to that proxy process, I'm quite sure. Let's talk a little bit about the aftermath of Sarbanes-Oxley and assessing this new regulatory regime. Keith, I think you would be a good one because you know what it's like to deal with the kinds of tasks that legislators set. So tell us a little bit about the aftermath of Sarbanes-Oxley and the process of the integration and the rulemaking.

**Keith Higgins:** Well, I thought we would talk a little bit about listing standards and how the SEC got into the business of listing standards. Sarbanes-Oxley had a ton of rulemaking and some of it is disclosure-related and some of it was listing standards-related. The interesting thing, when I was asked to speak about the SEC and the exchanges on listing standards, I thought to myself well, we're not even the division that regulates the exchanges. We don't approve listing standards; we are the disclosure folks at Corp. Fin and we deal with the disclosure under the '33 and the '34 Acts and I found it a little bit odd that the director of Corp. Fin was to talk about the exchanges. It's really because of what Ann referred to as this kind of crazy patchwork that we have where governance standards are now implemented through at least at the federal level, principally through listing standards. It's either direction from the Commission to the exchanges, which if we go back historically, didn't work out too well in the early 1990s when the Commission decided it wanted to wade into the one share/one vote arena, and learned that it didn't have the authority to impose upon the exchanges and public companies, the one share/one vote principle, but of course the exchanges could on their own propose. There was a different standard that applies to the Commission, indeed the Commission is required to approve a listing standard proposed by the exchanges to the extent that it is consistent with the Exchange Act as opposed to being compelled. So, that is the curious situation we find ourselves in on listing standards and we have seen it in Dodd-Frank and I guess going back to Sarbanes-Oxley where the legislation directed the Commission to adopt a listing standard that prohibited the listing of any securities and ensured that it didn't have an independent audit. So, that worked out pretty well.

Taking a page from that playbook, we went to Dodd-Frank and Dodd-Frank did similar things. We could pick out a number of examples, but one is on claw-backs, which is still under consideration in the division and in the Commission. But, that was a direction to the Commission to adopt rules that prohibits the listing of any security of any issuer that does not have a claw-back policy. So, it's a funny situation. I find it really odd. You read the statute that says "The Commission shall direct the exchanges." It's like they turn to you and say "Tell them to do this;" they say "Okay, you do this." Nobody would really design that system.

**Cynthia Fornelli:** Then you have the approval afterwards too, and it is the same thing under Sarbanes-Oxley. The PCAOB comes forward with a standard and ultimately the SEC has to approve that standard. So you get into an additional layer, which is not all that transparent necessarily, to investors and others into that process. How much oversight does the SEC have over the PCAOB? When does the SEC weigh in on some of those issues? That is not wholly transparent. I think it puts, sometimes, the SEC and the PCAOB, in the case of Sarbanes-Oxley, in an awkward position.

**Keith Higgins:** It's a funny situation as well, where two principal exchanges, the NYSE and the NASDAQ, come up with different listing standards on the same topic and how should we think about that. Does it really make sense? I hear about the arguments "Oh, well, there ought to be room for exchanges to experiment if they're focusing on a particular kind of issue or not." I don't know; that does not really ring true to me or sound right. It seems to me if you are going to have a corporate governance principle. I think it's fair to say, back when I started practicing law, there was a difference between companies that listed on the big board and companies that listed on NASDAQ. It's not so much of a difference anymore. I don't think the kinds of issuers are choosing based on that.

**Cynthia Fornelli:** You see it in trading and markets looking at the FINRA standards too.

**Ann Yerger:** If I can, I'm just glad Keith discussed the listing standards, because I think it's easy to focus on Sarbanes-Oxley in the wake of the earliest part of our century and I think some of the most significant changes came from the stock exchanges, who in many cases, have not updated some of those rules for decades. They were stale and generally out of touch with even basic current practices at the time. I just want to expand on Cindy's comment about the pressure for change in the wake of those scandals. I would almost describe it as an imperative. An essential part of well-functioning markets is trust. When you don't have investor trust in the markets, they can't work. What happened in the wake of, particularly, the corporate scandals, there was a loss of confidence in the integrity of our markets. It really was essential that the regulators and the exchanges step up in meaningful ways to restore that confidence. So I would describe it less as pressure, and more an imperative for the capital markets.

**Keith Higgins:** You saw that even before the certifications required under Sarbanes-Oxley that the Commission was requiring the largest companies to...

**John Olson:** Harvey Pitt and Bob Herdman came up with the idea of getting the largest companies to make an immediate certification, which people said "You can't do that." and we said "Yes we can. We can require reports under the '33 Act. '34 Act, whatever act it is." And that led to a [CEO and CFO] certification being in Sarbanes-Oxley.

**Dr. Kenneth Durr:** Are there any other issues we should talk about as far as integrating Sarbanes-Oxley and moving through that new set of rules that followed before we get to the next big financial catastrophe?

**Cynthia Fornelli:** The only thing I would point out that we might want to take a minute on, was the creation of the PCAOB. So you had this mandate to create this new oversight body and as

we've looked over the last twelve years, a lot has happened in that twelve years and I think it's been a bit of a bumpy road. But I also think everybody would agree that for better or worse, and we all can find criticism with the PCAOB, it has been something that has injected investor confidence, injected a structure, injected consistency of standards, much as we were talking about earlier. And so, it has been an overall very good thing, but you saw the challenge to its constitutionality which had a big question mark about it and I think there's still, as mentioned earlier, some growing pains on the relationship between the SEC and the PCAOB. You have seen the board come up with the inspections process; now there's been a lot of focus in the last couple of years on the inspections process and getting that better refined. We met yesterday with board member Lew Ferguson and he was talking about part of the reason that you see more inspection findings, to the extent that you have, is because the PCAOB has gotten better at inspecting. Also, the inspection process now is more focused on high risk areas so it's natural that the inspection findings will go up because that's how the system has been built. You are just now starting to see some of that come to fruition because it is still a very new organization, if you think about it. We are celebrating the 80th anniversary of the SEC's existence. The PCAOB has been there, what, twelve years?

**Dr. Kenneth Durr:** Maybe one other thing that we should cover is the auditing standards. I think that AS2 and the transition from AS2 to AS5 tells us something about the process and maybe what doesn't work and what does. Anyone want to talk a little bit about that?

**John Olson:** That was really driven I think largely by the SEC and by Chris Cox and his senior staff who were responding to concerns by many of the issuer community that as originally interpreted in AS2, the 404 assessment by the auditor, the management's assessment of internal controls, was unduly burdensome and too document heavy and too much focused on process and less on the practical assessment. AS5 was worked out with the PCAOB somewhat reluctantly, but ultimately I think fairly amicably and I think did ease the tension. Today, I think the reforms that have been mentioned by Cindy - audit committee empowerment, CEO/CFO certification and one I mentioned which is the section 302 requirement that every public company have in place a system that allows anonymous reporting, protected reporting by employees of issues involving financial statements and controls and Sarbanes-Oxley also provides for anti-retaliation protection – these are really core provisions which everybody by the time we're about to talk about, the crisis of 2007 and 2008, had pretty much digested and accepted. I think the interplay between the Cox-led Commission and PCAOB contributed to that acceptance in the business community.

**Cynthia Fornelli:** It's interesting you mentioned the AS2/AS5 dichotomy. AS2 was all about effectiveness and making sure those internal controls were very robust. I think it's because of reaction of the financial reporting scandals. And then with AS5, the buzzword if you will, was efficiency.

**John Olson:** It's also risk-based. It's partly an evolution that has come with time. You've already done this very burdensome tracking through every single process and documenting it and hopefully that's been done and now you can move to a new level.

**Cynthia Fornelli:** Under AS5 the SEC came out with companion guidance for the companies as well, which was nice to have that coordination of the SEC telling the companies the expectations, and the PCAOB telling the auditors.

**John Olson:** What did happen right after AS2 was adopted, in the first couple of years of 2003 and 2004, we had a big spate of restatements, which resulted in a fair amount of litigation. And by 2008 that had pretty much subsided and that had an impact on the boards and on the companies and how people thought about governance. A lot more care by 2008 was being taken with financial reporting within companies by boards and by audit committees. I can tell you having worked for a lot of audit committees they really were empowered. They were very conscious that when the financial crisis came along that they had important responsibilities and they were very alert to things they ought to be doing and wanting advice on things they'd want to be doing, which was not the case prior to Enron and WorldCom the late 1990s, and 2001 or 02.

**Cynthia Fornelli:** And stakeholders interests are all aligned. Investors, audit committees, auditors, regulators, I would say even company preparers, all want the same things. We want a robust marketplace where investors are confident putting their money. And so if we think about it like that, all of these reforms are geared toward that ultimate goal. Sometimes it's the implementation, that is, the devil is in the details.

**Dr. Kenneth Durr:** That's a great example of implementation.

**John Olson:** In the private sector, CII and other institutional investors were pushing hard for a number of things, one was majority voting, and that was generally very successful fairly rapidly with large companies and the SEC didn't really get into that or need to get into that.

**Keith Higgins:** We really got into the 14(a)(8) process. When you took the combination of the 14(a)(8) process and then the rise of the proxy advisory firms recommending if you did not adopt something that got a majority of votes in the preparatory proposal that you would get recommended against in the next meeting and directors hated that.

**John Olson:** The SEC had mandated, going back to 1942, the channel that allowed the expression to occur, but I think actually it was not a tough judgment to say that it was ok to go to shareholders.

**Keith Higgins:** It's the kind of thing that of course should go to shareholders, like staggered boards.

**John Olson:** And then at the SEC there was a lot of things that I think turned out to be detours and not particularly productive, and I think Ann even agrees with me on that. One was mutual fund governance which was a particular shibboleth of Chairman Donaldson and the Commission didn't unanimously support it. It's always a bad thing when the Commission doesn't come together on something.

**Dr. Kenneth Durr:** Sounds like you'd have an opinion on that, Ann?

**Ann Yerger:** We actually don't do any work on that.

**John Olson:** And proxy access, which they spent a ton of time on. I think Ann does have an opinion because we've talked about this before.

**Ann Yerger:** First, let me just clarify a point about majority voting for directors because we have asked the exchanges to adopt a robust standard. I mean, it is laborious to do this on a company by company basis and this is where this federalism starts creeping in, because the fact is, I think easy for investors to step back and say "This is so basic and so fundamental to our rights of electing or moving directors, how is it possible that you cannot get rid of a director that is not supported by a majority of the votes?" So, we worked through Delaware and the American Bar Association, and bluntly, I thought the corporate bar did not step up where it really needed to here and as a result you return to the stock exchanges and eventually this may end up going to the Hill. This is sort of the environment that we're in. So I would say it has not gone far enough. The proxy access was a laborious fight and a disappointing outcome for folks and we will keep pressing there one by one.

**Cynthia Fornelli:** Jill, you mentioned the mutual funds under Donaldson and to me that's an interesting example of what happens when you've got an SEC Chairman trying to stave off legislation that might not be helpful to the marketplace over time. I happened to be at IM at the time that all that was going on and you had Donaldson really trying to get the Commission to come up with some regulation that would stave off some of the things that Congress was considering, and that was much more draconian. But you're right, it did cause a split within the Commission and some of the things he tried to do ultimately were overturned.

**Dr. Kenneth Durr:** This is a good place, John, for you to take us. I think you mentioned that -- you started into it a little bit earlier -- in the 2007-2008 period and was there a sense that corporations have more or less absorbed the changes following Sarbanes-Oxley?

**John Olson:** I certainly think so, at least the corporations that we worked with seemed, by that time, to be reasonably comfortable. Lots of trepidation at the beginning. In place within every company of any size, or almost every public company, were disclosure committees the CEOs and CFOs could rely on for their certifications. Just creating the certification created an internal process that led to better internal quality control and also gave the auditors comfort because it was part of the control environment. So a lot of good things happened in retrospect, and although I think I said publicly and foolishly when Sarbanes-Oxley was adopted it was kind of a dog's dinner because it was thrown together from all sorts of places with not a lot of thought, i.e., it was much less that kind of a thing than we later found with Dodd-Frank. (Laughter) The core provisions that Cindy and I have been talking about I think have worked quite well and have, in fact, improved governance. In many countries, there is basically a single national corporate law for public companies and we could have gone that way. We have never gone that way, but S-OX did some stuff that, although it may have intruded on state turf in some ways, I don't think was so intrusive as to be disturbing to a federalist and it is pretty well accepted.

**Dr. Kenneth Durr:** Jill, from your viewpoint would you say that corporations had sort of come to terms with Sarbanes-Oxley by that time?

**Professor Jill Fisch:** I think that's true. I think that a key difference between Sarbanes-Oxley and Dodd-Frank, we have not actually said Dodd-Frank, but we keep kind of hinting at it. A key difference is the core of Sarbanes-Oxley, even though it was described as corporate governance, was really financial statement integrity. All of the audit provisions that Cindy talked about, the internal controls, all of that goes to this base issue. That it had been really ignored, it had been out of date, it was critically causally related to the big corporate governance scandals in 2000 and 2001, Enron and WorldCom and so forth. So, we talk about has corporate governance changed? Sarbanes-Oxley is one type of corporate governance. We have thrown in and referred to a bunch of other stuff, shareholder proposals, majority voting, independent directors. Yes you can relate those things to financial statement integrity, but that is a much broader scope of corporate governance and that's where I think Dodd-Frank starts to look a lot more, both piecemeal scattered and also where we see more of this incursion or this relationship between federal and state law that hadn't previously existed.

**John Olson:** You're quite right. The difference in crises is quite marked. Pre-Sarbanes-Oxley, as Enron, WorldCom and various other things we could name were really situations where somebody was fiddling with the books or somebody was doing something inappropriate and that's why it produced the remedies it did. When you get to the financial crisis, that was primarily I think not a crisis of financial reporting, but a crisis of very bad management judgment in retrospect and frankly bad federal policy at the highest levels including the Federal Reserve Board, when we did not understand, in companies it was managers, we did not understand as a government the risk that we were taking. Buying into risk that was not understood. And that requires a different kind of remedy.

**Professor Jill Fisch:** Before we get into the causes of the financial crisis and we may be getting over our heads -- but before we get into that, let me just take us back to this issue of financial statement integrity. Because I don't think it is just about companies cooking the books and that's why I think Sarbanes-Oxley turned out to be much more successful than anyone anticipated. Financial statement integrity also has to do with transparency, with investors understanding businesses, with accounting rules responding to new kinds of businesses. We see that today. Look at Facebook and Groupon and all of these companies that have a completely different business model, where the process by which the financial statements are prepared and audited and communicated is critical to the marketplace being able to understand and value those companies. We talked about market discipline earlier. Financial statement integrity is key to that. I think it is much broader than just, okay this is a response to crisis, there were a bunch of people out there that were cheating and we needed to set some gates so that they could not do that again. Really, if you think about financial statement integrity in that vein that was part of the problem in 2008 as well. Because part of the issue with a lot of the financial institutions is you couldn't really look at their financial statements and understand the business, understand the risks, even the independent boards that were overseeing these businesses couldn't do that effectively. So, in a way, it's a financial statement failure again, just a different kind of failure.

**Dr. Kenneth Durr:** Can we see a transition from that failure to Dodd-Frank, what became Dodd-Frank? Is the transmission that simple or do we have more pulling things off the shelf and throwing things in the basket?

**John Olson:** I will tell you a short story. A Senator came to a group of us and said, "We need to do something right now to respond to the financial crisis." This was about 2009, I think. "Give us the low hanging fruit. We want to get a bill through the Congress right now." We said, "There's this Financial Crisis Inquiry Commission and there's all these other the studies, don't you think you should wait until we get the diagnosis before you prescribed the remedy?" And he said "No, no, I want stuff that we can do right now." There was a lot of that sort of "I'm going to run for re-election and I want to have a program." I think Dodd-Frank has an awful lot of stuff in it and some of it was mentioned in Dan Gallagher's speech -- that has absolutely nothing to do with addressing the financial crisis that began in 2007-2008. There are some things that do address the crisis, but unfortunately I think they address them rather indirectly.

**Dr. Kenneth Durr:** Jill, do want to touch on any of the others?

**Professor Jill Fisch:** A lot of Dodd-Frank is about some of the things that John referred to that had very little to do with corporate governance. All of the swaps clearinghouses, some of the bankruptcy for financial institutions. That's not what we're talking about here today. But I think a lot of that is directly tied to concerns about what I think we would all agree are at least major contributing factors to the financial crisis. When we talk about Dodd-Frank not being responsive to the financial crisis, and including a bunch of prepackaged ideas.

**John Olson:** Arguably, the Volcker Rule. You could argue that.

**Professor Jill Fisch:** Yes, but we are talking about the real governance stuff: conflict minerals, pay ratios disclosures, on pay and proxy access. The fit of those reforms to the events that triggered the crisis, whether or not they're good reforms, is a pretty poor fit.

**Cynthia Fornelli:** I am going to take a bit of a difference with your opinion with the financial crisis being financial statements-related. I don't see it that way. I think that the financial statements of these companies and some of the triggers if you will that caused the financial crisis really had nothing to do with financial reporting.

**John Olson:** Certainly not audited financial statements; I agree with both of you. I think, correctly understood, the control system, and particularly what we are now calling enterprise risk management failed in the crisis leading up to 2007/2008. That is not audited financial statements; that's a different issue that is related and it is something that audited financial statements rely on because they rely on the controls in the system and the control environment. But I don't think that it was audit failures. I agree with what you are saying.

**Professor Jill Fisch:** Yes to the extent that you understood me to say that these are audit failures. I was not saying that at all.

**Dr. Kenneth Durr:** There is no denying that with Sarbanes-Oxley we had accounting committee independence and with Dodd-Frank we get the executive comp committee. So there are other pieces that are tied to executive compensation. But why the focus on executive compensation in Dodd-Frank? Keith, do want to touch on that?

**Keith Higgins:** We are just the ones implementing the rules. I think Ann, you're in a better situation to speak to this.

**Ann Yerger:** I cannot speak to the motivations for all of the various provisions included in Dodd-Frank. I do agree that some of those I think were directly related to concerns raised directly by the financial crisis and others I think drifted just a bit more from that.

I think that on the executive pay front, there has always been an interest in this issue as we all know, everywhere - the media and the general public and the Hill. But I think the crisis did highlight concerns that compensation might be motivating or incentivizing excessive risk-taking. And I think it indeed might have been doing that. I think that's how executive compensation fit into Dodd-Frank

**Cynthia Fornelli:** A question, if I may. Do you think it was the amount of compensation or the type of compensation?

**Ann Yerger:** I think it's both amount and structure. I do think structure played a role and questions on how some of these packages were structured and incentivizing behavior that ultimately was risky and harmful to investors over the long-term.

**Professor Jill Fisch:** Yes and I think that executive compensation became such a key focus in Dodd-Frank because of those two things going on simultaneously. On the one hand, executive compensation is about what Dan Gallagher said: disclosures mandated to achieve social goals. We have been worried about executive compensation for years. People talk about it in terms of an agency problem and a concern for shareholder protection. But the criticisms are much broader on a societal level. So that's fair.

But at the same time, you also see crisis-related situations; where was the structure and the incentives of the comp packages that were a key factor. Think about the London Whale and risk management. This office was supposed to be charge of hedging with executives having not just huge compensation packages, but packages that were tied to profitability. Profitability and hedging are really not the same thing. And if you incentivize people to generate a profit, you are not going to get the kind of hedging that addresses the risk that John was talking about.

**John Olson:** And trading desks tried to make as much money as possible as opposed to hedging institutional risk.

**Ann Yerger:** And bringing back the points raised about Sarbanes-Oxley; a lot of the things in the comp piece included in Dodd-Frank have been talked about for years beforehand.

**Professor Jill Fisch:** Since the 80s.

**Dr. Kenneth Durr:** The question is, are these the best tools at hand for solving the perceived problem? I think that when we hit a point like this, you have your anecdotal discussion of "give

me something” and people are ransacking their toolboxes. What other approaches were not taken?

**John Olson:** That's a good question. I had thought about that and I think what I would like to see in retrospect would have been something that would have helped companies and directors as overseers of corporate life to focus more on risk and understanding risk. I think that's kind of hard to legislate. That is clearly something that was not done very well in a lot of places. Risk was not understood. And because it was not understood, some companies took on very high risk. A case that I only know about the reading in the newspapers: AIG with its credit default swaps, where there was apparently no offsetting hedge to protect AIG in case it was exposed, as it was.

I don't think there was anything venal there but I think it would have been good to have thought about what one might do going forward to be sure that people are in fact focusing on those risks. I think that is happening, but I don't think it is happening through Dodd-Frank.

**Cynthia Fornelli:** Another thing that can help is the work under Chair White and the work you are doing, Keith, on disclosure effectiveness. Things have changed so much since the SEC was created and we get our information differently. Disclosure documents that are mandated are very lengthy and oftentimes repetitive; when something goes in, it never goes out. Looking at disclosures and seeing if there is a way that they can be delivered to investors so that they can delve deeper, where he or she or it in an institutional situation can get more information, or where somebody else could just get the basics. You mentioned risk, John; I think it's hard to parse out in a company's disclosure what its risk factors really are. So I think some of that could help.

**John Olson:** Many of you know Mike Cook, who was the great initial chair of Deloitte & Touche. He said to me recently he had been reading risk factors for companies and he said they're absolutely useless. They go on for 20 pages and they list everything in there and they are written by lawyers and they are like insurance policies but they don't really tell one what the important risks are.

So I think that the SEC could, and that Keith's project is moving in that direction to try to help companies focus on, talking about critical accounting judgments and critical risks, and how they deal with them. That's what investors need to know.

**Ann Yerger:** This is about more meaningful and effective disclosure. I worry anytime when it is couched as disclosure overload. This is worrisome from an investor perspective, as you are taking away information people have been used to getting. The biggest challenge for the Commission is that different investors want different things. Materiality sometimes may not be one particular thing that is material, but in aggregate it is material. Those are the very complicated things that will have to be wrestled with as the Division proceeds with this project.

**Professor Jill Fisch:** And there is a nice academic paper out there that looks at the evolution of risk factor disclosure and noticed that it's a contagion effect, particularly within an industry, so that if one company discloses a new risk factor, than the next year a bunch of other companies in the industry pick it up and add it to their list.

**Keith Higgins:** The availability of the safe harbor for forward-looking statements under the Private Securities Litigation Reform Act is a large contributor to the reason that you have a kitchen sink approach to risk factors, because why wouldn't you put them in? If your forward-looking statements, which people are typically sued on, have to be accompanied by important factors with the results could be different than what you said in the statement then why wouldn't you simply include every possible thing? We need to find a way to have an incentive for people to write them better and write them shorter.

**John Olson:** The SEC started us down that road a few years ago when you're talking about how the company governs risk in general. But I think that has not evolved as robustly as we would hope.

One of the things that bothers my clients today - one good example is the general situation of General Motors and Target and it is what I call consumer facing or customer facing risk. What can happen to this company that will cause a loss of reputation and cause a loss of sales which will result in claims. It could be a security risk around credit cards, or product defects, or something else. But companies worry about that and boards worry about that but they're not quite sure what they're supposed to do about it, and I'm not sure what the SEC can do about it.

The other thing that we are hearing more about: what is the purpose of the corporation? Why do we have companies, why are the charters and the advantages of limited liability and access to markets made available to companies, presumably because ultimately they provide some social value: good products, jobs and so forth. Have we over-emphasized measurement of corporate success by looking only at earnings per share and growth, particularly on a quarterly basis? Should we be looking at broader standards? We could debate this back and forth and we could go into a never-never land with there no standards which is not good, or you can pick your standards and measure any metric that you want. Boards are worried a lot these days about who are the real stakeholders. For example, look at BNP Paribas. The people involved in that debate are the government of France and the government of the United States because of the systemic importance of BNP Paribas to the French economy. So some big picture items out there that now take up the time of people thinking about corporate governance in a way that has not been the case a few years before. I don't know that the SEC has a clear role in this issue.

**Dr. Kenneth Durr:** There's one more big picture item I want to make sure we touch on before we run out of time, and that is the proxy access issue. We ran into it before with a little bit of enthusiasm. We saw that beginning in 2009 when the SEC did some initial proposals, and then into Dodd-Frank. Can we talk about the progress of proxy access?

**Professor Jill Fisch:** John and I were passing notes but proxy access actually started at the SEC in the 1940s as well, about the time the SEC adopted the shareholder proposal rule. And then it's up and down in getting the Commission's attention for years. 2009 was not really the start, but what is out there and what has been debated and what is the possible governance reform that we can use the financial crisis as a trigger to move forward.

The problem is that I think that proxy access surfaced at a time that all of these shifts in the institutional investor community and how much they own and what the role is that what they're supposed to do, all of these shifts are very much in flux. So if you cannot figure what an institutional investor is supposed to be achieving or how should it be achieving it if you're worried about proxy advisors and different types of institutional investors and what it means to be a special interest in the governance space, it's hard to come up with a very workable proxy access rule. I don't think everyone was happy with Rule 14(a)(11) when it was adopted and while I think that the DC Circuit's decision creates a lot of much broader problems for the SEC and for federal agencies generally with respect to rulemaking, I don't think killing rule 14(a)(11) is something that a lot of people view as a tragedy.

**John Olson:** Ironically what we ended up with was what the business community and the American Bar Association were advocating, which is the ability of companies through their shareholder voting process to adopt a bylaw providing for proxy access if they want to do so.

**Ann Yerger:** The CII and institutional community are really united in getting the mechanics of the election and the removal of directors working. It does not here in the U.S. We don't have majority voting so you can't get rid of a director, even if the lion's share of the equity doesn't support the director. It is difficult and expensive to run alternative campaigns and access was seen as one mechanism to find another way of getting candidates for consideration. So that's why it was so important.

The fact of the matter is that investors clearly support it. I think every proposal that has been submitted that has had the three and three composition that was proposed by the Commission has won majority support, even companies that have adopted more stringent standards. I think the case of Nabors this week that had a 5% five-year combination towards the access standard that adopted and had a shareholder proposal was three and three and the proposal won support, so I think there is support in the investor community for the concept. I think philosophically we can agree or disagree about whether doing this with private ordering versus some uniform standard is the way to go. I think our community would generally say we prefer the uniform standard.

I will say that CII has pivoted a bit. We are focusing on the concept of universal ballots. So if there is indeed a full-blown genuine proxy contest with competing cards, we think it is very important that investors have the ability to split their vote between candidates and that really can't happen today unless you physically attend the meeting and that's a problem. I think that's a little more history than what you wanted to hear about why some of these reforms is so very important.

**Professor Jill Fisch:** But if the director election system is broken, and I certainly agree that it is, is three and three really a fix? When the SEC proposed Rule 14(a)(11), they admitted that two thirds of publicly-traded companies don't have a single shareholder that would meet the standard.

**Ann Yerger:** We agree that it is a very high bar. Workable and something that would be used only really extraordinary and exceptional cases which is why we thought it was a rule that the

corporate community should not fear. Ultimately what may happen is that three and three go forward, but probably evolve.

**John Olson:** What three and three means is that you have to have 3% of the shares and have held for three years and also be prepared to hold through the meeting. Which basically means as proposed with the SEC rule and things that have been adopted by a few companies as mentioned, it is only available to very large shareholders, not to the average investor and not a realistic route for groups of investors coming together.

**Ann Yerger:** But we expect this to evolve, and companies may rue the day they decided three and three was not a good combination.

**John Olson:** I think it's a theological thing. I think that if director relations are broken, we have to find other ways to address it.

**Cynthia Fornelli:** You mentioned the quarterly earnings pressure. Is there some root in the three and three that we are getting away from long-term investing and more towards trading? Where did that come from?

**Ann Yerger:** I think there is a general view that there should be a limited tool available to shareholders if you want access to management's card. I think that was the philosophy underscoring that.

**John Olson:** The original thinking on this was that in various places, including the Aspen Institute Corporate Value Strategy Group which in about 2007 gave a first statement on this. The members of the group included the Council of Institutional Investors and various pension funds, CalPERS and major corporations and some private practitioners.

The feeling of that entire group was that everybody benefits if management is managing for the long-term health of the enterprise. That's particularly true with the public employee pension funds because they're heavily indexed, and in the market to stay. That's one of the reasons they care about governance, because they cannot do the Wall Street walk. They have very large diversified funds.

I think that's where it came from but it's actually one area where the directorial and management community and the investor community comes together.

**Dr. Kenneth Durr:** Jill, you talked about the Business Roundtable decision. Did the D.C. Circuit leave some indicator of what direction the SEC would go as far as making rules that meet the mandate?

**Professor Jill Fisch:** I think with respect to proxy access what John said is absolutely right. We have gotten to the position now where this is being done through private ordering and we have gotten back with respect to 14(a) where proxy access proposals are a proper subject. That's what the pension funds and the union funds wanted back in the AIG case in 2006. So I don't see any great impetus for further rulemaking. But what I think is problematic about the D.C. Circuit

decision in the proxy access case is the suggestion that in order to regulate in this area, that we need to come up with some sort of sound empirical basis for validating the governance reforms that the regulators seek to impose and that is really problematic. Even in the business schools and the finance departments, we don't have the methodology to test in advance proposed changes to corporate governance rules to decide if they're going to help with long-termism, profitability or stock returns. You cannot do that. The most troubling part for me of the opinion was that the D.C. Circuit says that the empirical evidence is kind of mixed to so I don't think the SEC has made its case. The research on independent directors - academics have been studying board independence for years and the results are inconclusive. You look at separating the Chair and the CEO, whether you are for it or not. There are dozens of studies; the results are inconclusive. If you think that regulation is valuable in this area – you can think it's not and we should leave all of this to private ordering and the free market - but if you think that at least some regulation make sense, then you cannot have that as a legal standard.

**Ann Yerger:** It applies far beyond corporate governance. Investor protection is very difficult to quantify; regulation is very easy to quantify the cost. I do generally worry for the Commission that it now has to get twisted up about cost benefit. That is so important that it be done but you cannot do perfectly or precisely. But that in itself may slow the Commission so profoundly that it will make the functioning of the organization I think really problematic.

**John Olson:** I'm an optimist on this and I think that case, with full disclosure that my partner, Gene Scalia, won the case, was a low watermark for the SEC in terms of having rules struck down. I think the opinion was unduly harsh on the SEC. But as a result of that and other decisions in the D.C. circuit, the SEC, first under Mary Schapiro and now under Mary Jo White, has created a Division of Economic and Risk analysis (DERA). DERA's doing a great job of getting into the rulemaking process from the start. Taking the point that Jill made, and headed by this wonderful guy Craig Lewis who just had to go back and teach at Vanderbilt, they don't take the view that you will be able to quantify everything, but they did say you should quantify what you can and you should be candid about what you can't. They did that in the conflict minerals rule but the D.C. Circuit struck that rule down but on a very narrow First Amendment ground, and, in the opinion, they said they could essentially not find any problems with the economic analysis, with the efficiency, with the capital markets, and so forth tests that are in the securities laws as a result of NSMIA. I think that is a sign that the SEC is going to be okay as long as they do a candid analysis. I think the problem they ran into – fairly or not – was the court in Business Roundtable, reading through the analysis, came to the conclusion that it was not candid, that it was self-contradictory in places and some of the evidence that had been submitted by commenters had been left out. That will not happen again because the SEC, I believe, is taking economic analysis seriously.

**Cynthia Fornelli:** I wonder if it's time to start thinking about other ways to get to some of this. One thing is if there are ways to differentiate between a cost--benefit analysis and an economic--impact analysis. I don't think you'll get the empirical evidence that you are talking about, Jill, but I do think that if we stepped back and look at the regulation after a period of time - how it can be tweaked, how it can be improved - then I think that there are tools and justification for either a legislative fix, if needed, or things that the SEC can self-implement. It could take some of the

cost benefit analysis pressure off. I'm not quite as optimistic as you are, John. I do worry that we are going to get tangled up in some of this.

**Dr. Kenneth Durr:** We have just a few minutes left and I want to extend some of the big picture comments that have already been made. I think that one is that we're looking at this very significant change in corporate governance that we have been talking about -- moving from states to federal. Are we grappling to come to some sort of new - for lack of a better word - philosophic understanding of what we are doing and of what corporate governance is about? Is that something that is happening or is it simply grappling with rules?

**Cynthia Fornelli:** I think that there is a bit of support welling up that we need to look at corporate governance outside of rulemaking or legislation. I think that part of that will be driven by what is going on globally. For a long time the United States was viewed as the leader in corporate governance. We might be losing some of that edge because you see other countries and other jurisdictions imposing corporate governance reforms at a quicker pace than we are, whether because ours get mired down in cost-benefit analyses or legislation. But I think philosophically there is a lot of support for corporate governance. And for whatever reason we stumble through some of the implementation of the mandates.

**Ann Yerger:** I will make an observation that I think that the CII and our community increasingly looks outside the U.S. for standards and ideas and practices because the fact is, in terms of investor rights, we are weak here relative to other countries. I still think we have the best regulated and most transparent markets, but in the government space, our investor rights here are in some cases weaker. And so we are increasingly taking cues from outside of the US. I think that is happening with all types of regulation.

One of the biggest changes at least in my opinion over the past decade has been that the corporate governance debate/discussion is not as hostile. It really did used to be fairly hostile and it really is not like that anymore. I think a lot more is happening quietly behind closed doors. Frankly I wished we never have to have regulation on these issues. That would be the best solution.

I think that companies are much more agreeable to talking with their investors and listening and it is mutual. And that has been a big change. And that may shape a lot of things and that may shape expectations for regulation on down the road.

**Dr. Kenneth Durr:** That is a great point to close on. We are coming to the close of our program and I want to thank Jill, Cindy, Ann, Keith and John for a great discussion.

Today's broadcast is now permanently preserved in the virtual museum and archive of the history of financial regulation in video format. An edited transcript will be added later.

This program also be an important addition to the Center for Audit Quality Gallery on Corporate Governance. I thank the Center for Audit Quality for its generous support and assistance in making the gallery possible, and encourage you to visit it when it permanently opens in the virtual museum and archive on December 1<sup>st</sup>. Thank you for being with us today.