PANEL 1: CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS

Moderator: William T. Allen
Panelists: Carol Bowie, John C. Coates,
Justice Jack B. Jacobs, Vice Chancellor Stephen P. Lamb,
Theodore N. Mirvis

Bill Allen: Judging by widespread public discourse, the corporate governance questions that are raised by the financial crisis are numerous and significant. We have a great group to explore some of them on this panel. Lets begin with the fact that the SEC has recently promulgated (again) a set of proposed questions relating to a proposed rule change respecting proxy access. Now, the proxy system is really close to the nerve of the control mechanisms of large public companies. In promulgating these rules, the SEC has some introductory language in which it says that weak corporate governance was an important factor in causing the financial crisis that we're working our way out of now. So if I may I would like to to suggest that we discuss in a general way, the question, has corporate governance, or defects in our corporate governance structure, contributed to this financial crisis? And just to get this conversation going, I'll start at the other end of the table and ask Professor John Coates if he can give a reaction.

John Coates: Sure. So, in my view, it depends a little bit on how you ask the question. If the question is "Is corporate governance, or widely practiced corporate governance structures, responsible for the financial crisis, or to what extent," I would say "very little, if any." And the reason for that is pretty straightforward: the crisis was caused essentially by six or eight firms, and there are more than ten thousand publicly held companies, and so if you're asking about corporate governance of public companies generally in this country, the vast majority of companies, therefore, the vast majority of corporate governance practices, really had very little to do with causing the current crisis.

If you ask the question a little differently, which is, if you focus in on those organizations that are responsible for what happened, I still don't think you can confidently make, at this

Imaged with Permission of N.Y.U. Journal of Law & Business

point, a lot of assertions about corporate governance, even at those firms, in contributing to the overall crisis. The reason I say that is twofold.

First, other types of organizations, privately held organizations that don't have the same corporate governance attributes, suffered quite badly in the crisis as well. Privately held hedge funds, where the structures are much closer—pay structures, ties between performance and management—much closer to the sorts of things that Jesse Fried was, I think, very persuasively recommending large companies think about, also have done quite badly. Many of them have failed in the current crisis. And so, that's one point.

A second point is that there are a number of contributing factors to the financial crisis that are self-evidently more important than corporate governance, such as the weakening of due diligence standards in the issuance of asset-backed securities ("ABS") largely following SEC rule promulgation in the early 90s, and no follow-up by any other governmental agency to look over the ABS market; excessively lax monetary policy, even as the housing bubble was beginning to be recognized by people within the Federal Reserve; government subsidies for low-income housing, which I'm totally in favor of, but without a recognition that that can have an unfortunate backlash effect on the financial markets; and a general weakening of monitoring by regulatory agencies across the board. All of them, I think indisputably, are first order causes of the financial crisis, and more important than anything you can say generally about corporate governance.

Bill Allen: To John's list I would suggest adding the SEC's lax monitoring of the capitalization of the securities operations of investment banks. It was reported that Bear Sterns debt to equity ratio was in excess of thirty-to-one. This was an extremely risky proposition that had little to do with corporate governance, since investment banking was a competitive industry with generally excessively high leverage. But let me turn to Carol, whose professional life is spent entirely in the corporate governance world. What's your view?

Carol Bowie: Thanks, and I don't want to ruin your dinner plans here by agreeing too much with Professor Coates right off the bat, but I would say speaking for at least a part of the corporate governance community, that I don't think any-

Imaged with Permission of N.Y.U. Journal of Law & Business

one would argue that governance weaknesses were the leading cause—not by a long shot. That said, I would suggest that there were some governance-related contributing factors, three that I would point to. First of all, directors' responsibilities in the sense that directors ultimately do have a fiduciary responsibility to protect shareholder value. That of course is balanced with their desire and responsibility for oversight of the process of creating shareholder value, but clearly there were some failures there by directors to provide the necessary oversight. A related issue may be board leadership, which is crucial, some would argue, for effective oversight; independent leadership separate from the CEO. And third is the whole question of executive compensation and its role in the process, and that's certainly a component of corporate governance, but again, I certainly would not make the claim that corporate governance factors were leading contributors or causes of the crisis.

Bill Allen: I agree with Carol.

Carol Bowie: Good.

Bill Allen: But I would say, I really feel more strongly than she about this. I think that many people grab hold of the agenda that they had before the crisis and use the crisis as a way to advance whatever their policy agenda has been, and in doing so they probably are not thinking very much about what new information you get from the crisis.

It would be hard to say that corporate boards of financial firms acted optimaly. Invetsors naturally think, "Well couldn't you have done something to protect us a little more?" Some firms came out better in it than others, so there are differences. But think of yourself as a director of Morgan Stanley, for example, or even Bear Stearns. You're in control of an enterprise, but it's an enterprise in a competitive market. And you're sitting there with a thirty-three to one capital-debt ratio, and you say, "My God, look how risky this is. These securities we hold, if the market should go down—not tank, but if the market in these securities should just go down by five percent, we're out of business. Isn't this too risky?" Suppose you do bring this up at the board meeting, and the other directors say, "Yes, we have a lot of risk, but we think the market's not going to tank, number one. Number two, if we reduce our

Imaged with Permission of N.Y.U. Journal of Law & Business

capital to debt ratio to, say, twenty-seven or twenty-five per cent, it's going to impact our earnings of course. And we are forbidden to coordinate with others aspects of our competitive business such as levererage. So people are captured by the market dynamic, which really shows the essential role of regulation: not to cap compensation, in my opinion, but to set a framework in which the destructive forces of competition can be constrained.

So I don't personally blame even the directors of Citigroup, which is the company that by all rights should be totally bankrupt by now, but has been saved by the United States Treasury. It's hard to blame those people. They were stuck in a market in which everybody was looking at rising asset values and to deep a belief in the ability of financial economists to model things. Anyway, let's get someone else taking rather than me. I know that Ted agrees with me because I cleared all these remarks with him first.

Ted Mirvis: I would suggest that if you wanted to frame the discussion in terms of whether or how corporate governance contributed to the crisis, I'll disagree with everybody. I'll say it played a direct and important part in the crisis but in a little-observed way. The defect in corporate governance that contributed significantly to the crisis was the empowerment of stockholders.

You alluded to the fact that when proxy access was proposed, the SEC Chairman's comment was that the current crisis had led investors to raise concerns about accountability and responsiveness of companies and boards to the interests of stockholders. I think a very interesting fissure has been created among people who were normally allied on this subject. Senator Schumer, when he proposed the Shareholder Bill of Rights Act of 2009, which of course has proxy access, as well as elimination of staggered boards and separation of chair and CEO positions, as its centerpiece, made the comment that during the recession the leadership of the nation's companies took too many risks and too much in salary while the shareholders had too little say. He made the statement that this legislation, his bill, will give stockholders the ability to apply the emergency brakes the next time the company management appears to be heading off the cliff.

Imaged with Permission of N.Y.U. Journal of Law & Business

Now we heard just the opposite last night from Professor Bebchuk. Professor Bebchuk basically made the point that the stockholders were driving the bus off the cliff during the financial crisis because they were demanding excess risk-taking by their managers because they were investing in firms that had the backdrop of too big to fail and federally insured deposit bases. John Macey made essentially this same point in the Wall Street Journal last week in a piece called "Obama and the Fat Cat Bankers."[1] He made the point that public shareholders of fat cat banks tend to be highly diversified against the risk of failure of any particular institution, so they (stockholders) have a strong personal interest in seeing that bankers who manage their leveraged investments swing for the fences. After all, Professor Bebchuk has been called rightly the Elvis Presley of stockholder activists, and here he is, I thought, squarely placing at least some accountability on the stockholders for the conduct of the firms that in fact failed.

Bill Allen: Last night many of you were not able to come. Lucian Bebchuk did recognize the fact that with respect to financial enterprises, the holders of the firm's equity have an incentive to take excessive risk because they are playing on top of a huge pile of depositor's money and of capital market bonds and things, and they get the upside and they have the implicit protection of too big to fail. So he recognizes the problem of shareholder empowerment . At the same time, his solution to current problems is increased shareholder voice, greater shareholder power. I think this is an example of what I mentioned earlier of people having bought into a model of corporate governance and an agenda of repair which really doesn't fit the current situation. The crisis shows you that increasing shareholder power is not the end all and be all of sensible economic regulation. Anyway, Carol what do you have to say about that?

Carol Bowie: Again, I'm certainly not going to disagree that the financial institutions are separate animals for the very reason that you mentioned. There's downside protection in

1. Jonathan Macey, Opinion: *Obama and the Fat Cat Bankers*, WALL ST. J., Jan. 12, 2010, *available at* http://online.wsj.com/article/SB10001424052748704081704574652622742100550.html?mod=rss_Politics_And_Policy#printMode.

Imaged with Permission of N.Y.U. Journal of Law & Business

the form of the taxpayer's treasury. So I don't think that you can look at it the same way, and again, I was not arguing, and I wouldn't, that corporate governance failures were the major contributors there. That said, I don't know that I would look at shareholder power as some kind of monolithic force either. Clearly, shareholders are interested in value creation and in seeing the value of their portfolios go up. On the other hand, they don't want to see it suddenly go down to zero either. That's why they hire directors—to try to ensure that doesn't happen. I don't know that I'm disagreeing at all, again. But I think corporate governance has a place. It is a contributing factor. The financial institutions are separate entities because of their status within the economic system, almost a little like a public utility, one might argue.

Stephen Lamb: Bill, can I ask a question? I wasn't able to be at Lucian Bebchuk's talk last night either. But I wonder about this idea that stockholders of financial institutions really are protected by the too big to fail regulatory scheme we have. I mean, my understanding is that in most cases the stockholders of these institutions, at least many of them, got wiped out.

Bill Allen: Well not in Citigroup.

Stephen Lamb: Well in Citigroup they didn't get wiped out, but—

Bill Allen: They lost a lot.

Stephen Lamb: Their stock has gone from $30 or $40 to $3. I mean, that's not some happy outcome.

Bill Allen: Well, just because they have incentives to take excessive risks doesn't mean that there's no scenario in which they can't lose. It just means that they have an incentive to take excessive risk.

Stephen Lamb: But they have an incentive to take excessive risk for lots of reasons, most of which, I think, have to do with diversification. But very little have to do with the fact that when they fail the government's going to come in and bail out the bondholders.

John Coates: Can I jump in here? I want to link that point back to Carol's observation that a lot of shareholders lost money in the recent crisis so how could you blame them? Yes,

Imaged with Permission of N.Y.U. Journal of Law & Business

shareholders have reasons to want companies to take greater risk whether it's because of across the board diversification or because it's reinforced by moral hazard and depositor guarantees. There's a big difference between the ex ante goals of shareholders, that is what shareholders want before the investment bets have paid off—

Stephen Lamb: I was wondering how long we'd go before we got to ex ante . . .

Bill Allen: It's a record now, 5 minutes.

John Coates: Well, it's a crucial point that I sat this summer and failed to get across to Chuck Schumer who made exactly the same points. He just couldn't take in the idea that shareholders could ever want something that would produce a loss to shareholders. And that's just wrong. It's a fundamental mistake. Shareholders want companies to take risks. If companies take risks, sometimes these risks will pay off badly and when they pay off badly it will look in hindsight like this was always bad for shareholders, so shareholders couldn't have caused this. They couldn't have contributed to this problem.

Stephen Lamb: Yes, I understand that point completely and you're right obviously.

John Coates: And the point goes to Carol too. Carol, you can't infer that shareholders didn't contribute to Goldman's desire to make more money by making massive bets and hedging the downside implicitly through AIG with government money, simply because Goldman lost money. It's just the wrong way to think about investments.

Stephen Lamb: Let's circle back again to the role regulators played in this, whether it's the SEC or the Fed or any of the other bank regulators. In my estimation, it's hard to overstate how much they took their eye off the ball and how much they were responsible for this. Along with imbalances with trade with China.

Bill Allen: Hear! Hear! I agree completely.

Jack Jacobs: Just as an endnote on this issue of whether or not corporate governance was a cause of the financial crisis. To the extent this group has a consensus on anything, the consensus I gather is that there is no relationship between failure

Imaged with Permission of N.Y.U. Journal of Law & Business

of corporate governance, defined either broadly or narrowly, and the financial crisis—with the possible exception of a few players in the financial industry. And even then, the relationship, if any, is very vague. I agree with all of that. But I think the critical question is, so what? The consensus that we appear to have has certainly been echoed in scholarly studies and other opinion makers' presentations in the popular media but none of that seems to have had any impact on Washington. Certainly, it has not had any impact on the United States Senate or at the SEC. So, regardless of what the facts may show, we are going to be faced with some sort of, I think significant, governance reform if any of these proposals come to pass, and certainly at the SEC they will.

Bill Allen: Thank you Justice Jacobs, that is a brilliant segue to Carol. Ted mentioned the Schumer bill. There's also the Dodd bill. So, if I may, I'll ask Carol to introduce this subject that Jack brings up; what is likely to happen in Washington and what is not.

Carol Bowie: Thanks, I brought extensive notes on the pending legislation. As probably most of you know, there was one bill that passed the house, Barney Frank's sponsored legislation. And certainly the provisions in these bills are far reaching governance reforms. I would not say that they grew directly out of the crisis, however. I think we do all agree that there are some in the industry who see the crisis as a window of opportunity, much as the Enron and WorldCom crashes were similarly seen as a window of opportunity to address longstanding desires by some shareholders.

The House bill that passed would make an annual, nonbinding say-on-pay vote mandatory. Also, that bill, which in retrospect is actually fairly narrow in scope compared to what's going on in the Senate, would require enhanced standards of independence for compensation committees as well as compensation consultants, and disclosure about the use of compensation consultants. The compensation committee independence, just to clarify, this sort of mimics what happened after Enron through Sarbanes-Oxley and the listing standards regarding audit committee independence. Directors could not receive any compensation from the company outside of their board service fees.

Imaged with Permission of N.Y.U. Journal of Law & Business

I'm going to really focus on the Dodd bill which essentially superseded the Schumer bill, although there's a lot of overlap there. So just to run down some of the provisions, this is actually kind of a nice handy top ten list. Starting with number one, the Dodd bill in its current form would direct the SEC to enact a proxy access rule. Unlike the Schumer bill it does not include any requirement for any particular provisions; Schumer would have required a minimum of one percent ownership for two years.

Two, Dodd would establish a majority vote standard in uncontested director elections. This is another sort of foreign import, a very common standard outside of the U.S., which traditionally has the plurality election standard for directors. Majority voting is one that has been kind of organically spreading by private action, through shareholder proposals and companies agreeing to do that. And under Dodd's legislation some companies will be exempted, smaller companies.

Three would require under Dodd's bill that investors approve any classified board structures (i.e. staggered boards rather than annual elections). Schumer would have required annual elections; Dodd would require classified boards to be approved by shareholders.

Four, and this has been essentially preempted by the SEC's recent proxy disclosure enhancement rules, is more explanation about the board leaderships, requiring companies to explain why they think it is necessary to combine the chair and CEO positions. This one is essentially enacted through the SEC rule.

Five, a requirement for annual say on pay advisory votes, just as Schumer would have, but potentially allowing the SEC to exempt small companies; also a separate vote, I believe advisory, on golden parachute arrangements related to change in control. Six, again stringent independence rules for compensation committee members. Seven, more disclosure related to compensation consultants—another one that has been really preempted by SEC rules which now require much of that. Eight, disclosure about employees hedging transactions, and this is peripherally related to what Professor Fried was talking about in terms of executive manipulation. There's a lot of thought that when executives can hedge their company stock

Imaged with Permission of N.Y.U. Journal of Law & Business

that they hold, essentially insulating themselves from downside risk, this has a detrimental effect on behavior.

Nine, requiring a clawback policy. Someone asked about clawbacks, and Dodd's bill would require clawbacks going beyond the Sarbanes Oxley rule which focuses strictly on the CEO/CFO as well as on misconduct—under Dodd's provisions, any misstatement that ultimately results in a restatement taking back earnings would be subject to clawback.

And then finally ten, which really is focused on the bank and holding companies and depository institutions, is instituting more stringent pay restrictions for employees of those institutions. I think that is also being taken up by other regulatory bodies.

So that's what's on the table. Of course Dodd's recent announcement of his retirement has opened up a lot of questions about the future of this legislation. There's a school of thought that he'll want to pursue it rigorously to leave a legacy and then there's another school that he'll be more open to compromise and a little more conciliatory without the political pressures.

Bill Allen: And all of this is one piece of his bigger financial regulation, deregulation bill.

Carol Bowie: Exactly.

Bill Allen: Well there's a whole shopping list of things that we can talk about. Maybe we can start on the compensation piece. Professor Jesse Fried has already more than ably introduced the topic so we shouldn't spend too long on it, but I asked Stephen Lamb to think about it. Steve do you think that the fixes that are in the Dodd bill are material, will be beneficial, will be window dressing? Do you have any view on that?

Stephen Lamb: You know, you sign up for these panels and you are told ahead of time what you are going to be asked and at the last minute you are thrown a curveball.

[Laughter]

I think everyone on this panel would agree, even Professor Fried, that there isn't any reason to believe that compensation schemes in place themselves played a really significant role in the crisis that we've all been living through. I suppose they played some role, and I think people are probably more apt to think that compensation had something to do with it

Imaged with Permission of N.Y.U. Journal of Law & Business

than corporate governance. In Professor Fried's talk, though, most of the bad things he was speaking about sounded a whole lot more like Sarbanes-Oxley type problems—things that happened in Enron that Carol spoke about, or things that happened at MCI—real fraud, cheating, misstatements, the backdating of options, that sort of thing. And at least to my knowledge so far there isn't really anything to suggest that any of those things played any significant role in this crisis.

So I think we should be clear what it is that we are talking about. Compensation policies create human incentives for the people who are subject to them, and incentives drive behavior. Whenever I think about things like that I always go to Charlie Munger's book, Poor Charlie's Almanac. Charlie Munger is the expert at talking about what incentives do and how we control incentives. And I think the very simple thing Charlie would say is that you're not going to perfect the overall solution by your compensation policy alone; your compensation policy is just one piece of how a corporation regulates the behavior of its executives. Whether there are internal control policies, whether there are risk management systems, whether you have strong and effective accounting rules that govern the way you report your earnings to the world. To the extent those things are weak, then you are going to have problems in that the incentives that you build into your compensation system may run amok. So you need effective accounting.

I found this great quote in Charlie's book, and he was really talking about accountants and weaknesses of accountants that are evident from time to time, or I think you can apply it to internal control processes that aren't as strong as they should be. The quote is: "Whose bread I eat, his song I sing." That is, if the person running your internal controls program is responsible to the people who he is trying to control, or if the people who run your risk management system are governed by or controlled by those who are taking the risks, you are not going to have an effective program. And your compensation system I think is just a small piece of that but these other things bear looking at—and they don't bear looking at by Congress, in my view—they bear looking at by people running businesses and by people who own businesses. There isn't going to be a risk management system that fits everybody; there isn't going to be an internal control system that fits everybody; and, at least under GAAP, there isn't an accounting

Imaged with Permission of N.Y.U. Journal of Law & Business

system that fits everyone. I think there's a couple hundred various GAAP rules on accounting for income or recognizing income.

That's my take on it, Bill. Sure, its probably the case that if we look at companies that were originating mortgages or paying people just to originate mortgages and taking the risk and pushing the risk completely off their balance sheet to somebody else, they may appear to have had crazy compensation policies in place. But actually, they had very sensible compensation policies in place if they were paying people to generate mortgages because, from their point of view, on a risk adjusted basis, it really made sense. What you really need to look at internal to a particular company is, on a risk adjusted basis, did the compensation systems make sense.

But more importantly there are external systemic risks. If I can push all my risks to the next person, I'm happy generating as many mortgages as I can. Who cares about underwriting standards? If there's no one watching, that's what going to happen. There have to be people regulating the system so that those risks just can't be pushed down the line. I don't know if it has a whole lot to do with compensation but there it is.

Bill Allen: Well, I take it from your quotation of Charlie Munger eating bread and singing songs that you're in favor of greater independence of the compensation consultant who plays a pretty key role in creating these plans. So we should be concerned about whose bread the compensation consultant—

Stephen Lamb: Well sure, another Charlie Mungerism is the reciprocity effect. I mean you don't want the CEO of Company A being Chairman of Company B's compensation committee when Company B's CEO sits on his board or his compensation committee. And it goes deeper than that because, quite frankly, if the CEO is too powerful in a corporation, then the directors' pay, their perks and how they live their lives will very much be influenced by how the CEO feels about them. So the reciprocity effect can operate at that level too. Anyone who has advised boards has probably seen it. For example, after a CEO gets a new and better pay package, it may not be unusual to observe an increase in board compensation.

Imaged with Permission of N.Y.U. Journal of Law & Business

Carol Bowie: And again, I certainly wouldn't disagree with a lot of what you said, especially the part on the compensation front. We're not talking simply about greed, or anything that was irrational, but rather pay programs that were designed to over-reward risk taking. And so the employees were doing exactly what they should have, in the absence of proper oversight. But again, that's notwithstanding the fact that at the end of this road are the regulators who were falling down on their job, clearly. I haven't heard anybody except maybe Nell Minnow say that the regulators did not have major responsibility for the crisis itself. But on compensation, I don't, either speaking for RiskMetrics or myself, necessarily think that a one-size-fits-all on some of these provisions and that what would be implemented under Dodd's bill is the simple answer. But I do see it as an array of controls for these situations that do crop up. They don't crop up at every company, to be sure, but they do crop up. The too-powerful CEO, the directors who are not accountable. How should they be addressed? State by state is what you would recommend. Company by company?

Stephen Lamb: Of course.

Bill Allen: Well, this is a fundamental and interesting issue. We at this Law School have many international connections. One of things we have is a Hauser Visiting Scholars program so we get a lot of European and Asian professors who come to spend six weeks or a semester here each year. They used to be asked to give luncheon talks to the faculty, and always the Europeans, no matter what their field was, would make some kind of talk, the implicit basis of which was that harmonization in law was good; one rule was good. And, at least for a part of the American faculty—the part that was interested in Corporate Law at least—they were always skeptical because they generally believed in the notion of decentralization; competition among regulatory regimes producing better outcomes.

And so it's a fundamental issue. You can get efficiency by reducing transaction costs if you have one rule for everybody that is the right rule. But one must ask how do you figure out what the right rule is? And if you have one central rule, even if it's close to the right rule at point A, it probably won't be for long. So this is a deep dynamic as to whether you want decentralized or centralized rules.

Imaged with Permission of N.Y.U. Journal of Law & Business

Stephen Lamb: May I point out though that in the last 20 years, boards of American public companies, at least major corporations, have gone from being half or less outside directors to being nearly entirely outside directors. And these people are increasingly more stringently outside, independent people. So now that you have all these independent people in the boardroom, whose job principally is to pick the CEO but to make other major decisions as well, why isn't that the point at which government intrusion or regulatory intrusion into board processes should stop?

Bill Allen: Our time is short, so with your permission Vice Chancellor, may I turn our conversation more directly to issues of compensation. I would like us to hear Professor Coates on that subject before we finish, but first I want to call our attention to a very interesting finance paper on CEO compensation published recently.

Two professors of finance at the Stern School, Gabaix and Landier—they both happened to be French—did a very interesting study.[2] They had a theory that assumed there is something called "CEO skill," in which a particular type of individual can actually add value. Now it may not be an assumption you want to buy into, but they say imagine that there is CEO skill and that CEO skill is worth more to bigger companies than to smaller companies. And that's obviously true: if there is such a thing, when it's levered over a bigger asset base, it's going to be worth more. Now, take that assumption, and then just imagine that sometime in the past, I think they picked 1955 or 1960, that CEOs were well-compensated or correctly compensated. Now, model the growth of the real economy just in absolute terms, I think they did absolute terms and in real terms, and look at the pay that existed back in that golden age, and see where the CEO pay would be if that ratio of pay were applied to firms of the current size. They created a model and then they put their model up against the current data and they predicted practically 100% of current average CEO pay. Interesting.

2. Alex Edmans, Xavier Gabaix, & Augustin Landier, *A Multiplicative Model of Optimal CEO Incentives in Market Equilibrium*, Review of Financial Studies, vol. 22, 2009, at 4881-4917 (2009), *available at* http://ssrn.com/abstract=999096.

Imaged with Permission of N.Y.U. Journal of Law & Business

Carol Bowie: Did they look at all employee pay by any chance?

Bill Allen: No, I don't think so. They looked at CEO pay. Why should they look at all pay? You mean that CEOs are making more than shop floor workers, a higher proportion?

Carol Bowie: No, but there's a presumption there that because the CEO pay is aligned, does that mean that the CEOs are solely responsible for that growth?

Bill Allen: No, there are lots of things that are responsible for the growth of the entire economy. Their assumption only is that a CEO with greater CEO skill will in a competiotive market be worth more (be paid more) by larger firms. If you put that skill onto bigger companies, it will add greater value and demand greater reward. And in a competitive market for this CEO thing, you would get this pay. Anyway, I recommend this study to you, if any of you can understand it. I cannot. I have to read the summary of it. Jack?

Jack Jacobs: Can we double back for a minute? My thought is prompted by some things that Ms. Bowie said, particularly with regard to this panoply of regulation that we're facing that would impose even more independence requirements on board committees and particularly on compensation committees. You have to wonder what road we're being led down in terms of independence. I mean, independence is a wonderful term—it's like motherhood and apple pie, but the question is, what is going to be the practical import if all of that comes to pass? In that regard, and I hope I don't put him on the spot, but a few days ago I was on a program with Ted Mirvis, who had some very, very trenchant observations to make on this topic. And I hope that he'll share them with us.

Ted Mirvis: I'll try to recall them. I think it's the same point Steve led up to. We have seen a sea change in our own life times of the basic model of board structure. I'll beat the drum again of the role of stockholders and stockholder pressures in causing there to be changes to the governance system and whether they have in fact contributed positively or negatively to the creation of value.

Before the takeover years, the old style board was the CEO and three or four of the key managers: the company's banker, the company's lawyer, the chief supplier, maybe a re-

Imaged with Permission of N.Y.U. Journal of Law & Business

tired CEO, and then, more or less, the rest of the board would be outside directors. But they were people who had skin in the game—maybe not always in the stockholder sense but they had a felt vested interest in the continuity and stability of the enterprise.

Then along came the takeover years— the 70s, 80s and early 90s—in which there was a great hew and cry against takeover defense. The thought was that whenever a board fought a takeover bid that was a penny or a dollar or two dollars above the current market price, it had committed a grave sin. And this was attributed to the fact that boards were too closely connected to the company in the manner I've described and that led to great pressure.

We now have a new model of a board. The new model of the board is the CEO is a member of the board. Congress apparently doesn't think the CEO should also be the chairperson—whether that is really a game worth a candle or not is a subject we can discuss separately. But the new model of the board is that the CEO is the only member of management on the board. The rest of the board are totally independent. And the independence has become a fetish. It has been defined that if you own too much stock you are not an independent. A prior employee is definitely not independent. Basically the rule is if you know anything about the business you are very suspect as to whether you are independent.

But this was all, I think, designed historically to fight off the argument of structural bias that came about in the takeover years. Is it conceivable that if the boards of Bear Stearns, Lehman, Goldman Sachs, if these were privately held enterprises, as they once were, and had the kinds of boards that they had at that time, that they would have gotten into the situation in which they found themselves in 2008, beginning in 2007? To me it's almost inconceivable. Now maybe that's really not a governance issue, it's really a question of ownership. Does it make sense for these type of firms, and I think there has been a great contribution in thinking by the crisis—the great contribution is we all sort of singled out financial firms for the critical role they play in the overall economy, as John pointed out. That basically the financial crisis was that bad things happened to firms that we could count on two hands and the spillover effect was on everybody else. So when we

Imaged with Permission of N.Y.U. Journal of Law & Business

think about it as a general governance failure or as a general corporate American problem, that's almost clearly a mistake.

But I do think a large part of it is attributable to the fact that we moved away from a model of board structure. And we're always solving the last crisis. I mean we reconstructed the methodology of a board because there was a felt need that people were too prone to fight off hostile takeover bids. Which is interesting of course because the basic theory attacking defense is that you should take a dollar above market. You should be short-termist. Now the same people who had that view use words like, well we should only pay not for short-term performance; we should pay only for durable performance, or sustainable performance. We should have bonus banks in which people find out five years after they've retired how much they in fact got paid. It's an interesting idea but it's. . .

Stephen Lamb: Where do you sign up to get this job?

Bill Allen: With respect to independence, let me ask John Coates, if he knows, have there been some studies of the effect of independent boards on performance?

John Coates: There have been endless studies, the net sum of which is that no one can say anything very clearly, in fact, about the effect of independence. I'll use my opportunity to use a line that Ted said I had to use, which is, corporate governance, the topic we are discussing, is not rocket science. It's actually much, much harder than rocket science. Because rocket science, think about it, all you are doing is taking something that doesn't move on its own and blasting into space. That's hard and it's challenging, and the space shuttle disasters teach us it's not easy. But compare that to taking a bunch of people and understanding how they function when you are prohibited from experimenting on them. You can't do experiments on people, right? So, actually we can only learn the effect that independence has by trying to do our very best to draw inferences in situations where, by design, we can't in fact run the counterfactual. Let's have a dependent board in the current environment, we don't have any of those anymore because we have moved whole-heartedly to a system of independence. So that is a long answer to say, the short answer is we don't really know.

Imaged with Permission of N.Y.U. Journal of Law & Business

Stephen Lamb: Can I add one observation to this issue of independence? We have now created boards that are essentially wholly independent, and we have given them a great deal to do. I don't think that anyone can rationally serve, well maybe some real expert could, but most people could not serve on more than two or three boards. And we pay them because they now have to spend a great deal of time doing this. They are paid more than a pittance, indeed many are now paid in the hundreds of thousands of dollars to do this job that's becoming increasingly complex, and yet are to remain independent in some legal sense. This can create tension. A law suit was filed the other day in Delaware naming as defendants members of the audit committee of a company who are absolutely independent people. One is the retired CFO of a major corporation, he was a cabinet secretary. He doesn't work at this company; he is a director. But he gets paid 150 or 200 thousand dollars a year for his service, and the allegations are now made in this complaint that he and the other Audit Committee members are not independent because they are paid too much money. Well, if you don't want to pay them so much, don't ask them to do so much.

John Coates: Can I pick up on one other point? I have been polite down here, but Bill did ask me to think about compensation, so I want to make one point about compensation before we move beyond it, and it relates to what Steve just said. Adding more and more to what the board is expected to do, not because they in their own independent judgment think it is the best use of their time, but because there is a regulatory system that requires them to do it. The latest thing is on compensation, right? So the SEC, in advance of anything that Congress is going to do, has already put into place something that I think will dramatically expand, yet again, the list of things that a board is expected to handle. In particular compensation, not at the CEO level, which it has always had as a major task, but relating compensation to risk assessment, which is a completely sensible idea for many kinds of companies like financial institutions and that is sort of the genesis of the rule, but the rule cuts across all public companies. Now think about what it practically means for a compensation committee to actually start getting into the relationship between risk and compensation in the rank-and-file. They are suddenly

Imaged with Permission of N.Y.U. Journal of Law & Business

going to have to review rank-and-file compensation in a way I don't think, traditionally, they have ever done. They are then going to have to start thinking about the relationship between compensation at multiple layers within the organization and the authority with which those employees are paid. So they are basically now having to get into micromanaging, in a way, the HR function. Now, clearly somebody has to be doing HR, somebody has to be thinking about those things, but do we want the board of Exxon thinking about the pay of the guy who is running the off-shore rig? Even though that is an important topic, it is not clear to me that that's the best use of the board's time. One of the problems in the regulatory sphere is that, as Ted said, we are always fixing the last problem. There is no pushback at the moment of assigning new duties to say, "Well if you assign a new duty, and we are not going to lengthen the day by more than 24 hours, something is going to have to come out of what the board is doing, what's that going to be." So implicitly the next problem emerges every time you add something to what the board is doing.

Bill Allen: A very good point. What happens is that the more we get the regulatory command structure operating on the board the less time the board has to think about the business, about succession planning, about strategy, about product development because you are doing all these government-centric things.

Carol Bowie: And I would just add: that rule in particular—having the compensation committee consider and sort of certify that there is no material adverse effect on a company from any compensation plan—I think there is a lot of head scratching going on in the investor community as well as to why the SEC chose to follow through with that.

Jack Jacobs: I think that another off-shoot of that movement is that it would further balkanize the committee structure. John you were talking about the compensation committee having to make judgments that really involve risk management. If that is right, it suggests that we should be combining the risk management committee, if one exists, with the compensation committee. And yet, at least two of the proposals that are coming out of the U.S. Congress would split off, and make independent, the risk management committee. So we really need to rethink, in a rational way, what it is that the

Imaged with Permission of N.Y.U. Journal of Law & Business

board should be doing and how that ought be accomplished. I am a little alarmed by what I am seeing coming across the transom from the congressional side.

Bill Allen: And that's right. The problem is, what we are doing is gradually, not in a thoughtful or comprehensive way, we are restructuring the legal corporate form as it has operated more or less successfully in this country for a century or so. It's a little bit like the financial system, which from 1980 to 1999 with the enactment of the Gramm-Leach-Bliley Act, the Fed gradually changed the nature of banking by interpretation of the Glass Steagall Act until we ended up with Citi Corp. and we ended up with these multi-function universal banks, but there was never really a thoughtful review of what kind of risks we were taking on. In the same way with the corporate form, in reaction to one moment—I won't even call Enron a crisis, just an event—we get a big set of federal changes. Now in reaction to something that, at least the members of this panel feel were not caused by defects in corporate governance, we are getting another set of federalized changes with the division between the chair and CEO.

We are evolving a form in which the board is going to have a lot of real management responsibilities, the chairman of the board is going to be running the ship. Well maybe that's the best system, but we shouldn't arrive there through a bunch of isolated, political decisions. On the other hand, I don't think we should arrive there at all; I will put my cards on the table. I think we should have a system of decentralized innovation and markets and allow things to evolve, because I don't trust if we have a conference in Washington or they appoint a commission of high level thinkers to come up with the one best idea for corporate governance, I would rather have a freer system.

So what issues should we talk about? The specifics, should we go to proxy access? That's a big one.

John Coates: Let me say real quick, just as a preface for this discussion, I mean, when Carol was going down the list of things that are in the bills, in fairness to Congress—someone should say something nice about Congress once in awhile—most of them in fact provide flexibility. Right? Say-on-pay is non-binding, disclosure about whether to have a split chair CEO provision is in the current Dodd bill, etc. So I will say,

Imaged with Permission of N.Y.U. Journal of Law & Business

although I love to beat up on Congress, too, they have been listening to some extent and have been moderating the bills as they've moved through the past year, to the point now that I actually think for the most part you can adopt most of these corporate governance provisions and I don't think it would be a disaster.

Bill Allen: But they're federalizing things that have evolved already in the world, so if they mandate de-staggered boards, then you make into a federal issue questions of board structure, for example.

Carol Bowie: But to John's point, the Dodd bill would not mandate classified boards, it would simply mandate shareholder approval of classified boards, which is different.

John Coates: It is deliciously ambiguous for lawyers, because it doesn't actually make clear when—and in effect every classified board has been approved by shareholders at some point in time, so you can be sure that's a federal case coming that way.

Carol Bowie: Some shareholders at some point in time.

Bill Allen: The current law is there's no staggered board that has not been approved by shareholders, because it either has to be in the charter, which is ordered by law adopted by shareholders—

Ted Mirvis: Except for Massachusetts corporations, all of which are staggered by statute.

Carol Bowie: Right. Well, and, more recently, Indiana, which gave a very short opt-out window to board classification just recently. Again, I think that probably illustrates one of the reasons why shareholders are a little more favorable towards the federal application of some of these rules, and not leaving it to the states.

Bill Allen: I wonder if they are. I know that you are. But I mean, what I observed is, for example, a large pension fund that I did some advisory work for about six or eight years ago, on their governance, and the people who were in charge of corporate governance in this big investor, which was hundreds of billions of dollars in investments, if you talk to the people in the governance—at that point it was an operation under the

Imaged with Permission of N.Y.U. Journal of Law & Business

general counsel's office, and there were three or four people who did governance and they had views about everything—if you talked to the people on the investments side of the business, they could care less. They were interested in the business, the returns, what they thought they were going to be in the future, and so forth. They didn't have a view. And the governance people—maybe things have changed, but they didn't look very much at business performance. They were interested in ideas about shareholder power and advancing an agenda of shareholder power.

Carol Bowie: That's a great point, somewhere in the questions that we were all considering, there was a question about shareholders' role in the crisis and so on, and I think you make a great point, there is a disconnect there. There's a disconnect between the ultimate owners, particularly the pension funds, who do say—and I take them at their word—that they have a long-term view, they're interested in corporate governance. You call it for the sake of shareholder power; I think they would argue it's for long-term, sustained value reasons, but, they are, in many cases, disconnected from the day to day management of their money, which may have a very short-term focus. And it is a problem.

Bill Allen: There are very few empirical studies that show that there are connections between what I call shareholder power and long-term performance.

Carol Bowie: I wouldn't say that. There's Gompers-Metrick; there certainly have been studies that have demonstrated that shareholder power, shareholder rights, tend to correlate with long-term value, firm value.

Bill Allen: I am familiar with it, but, we'd have to have a bunch of finance professors up here to get through that. . . Well I'm disappointed at this audience not interrupting us yet, jumping up in an impassioned way. Let's have a question or two, and then we'll talk about say on pay.

AUDIENCE QUESTION: Yes, a number of the things that were said raised a question in my mind of whether we're actually in the process of killing off the public corporation as we know it. There was an article in the New York Times, a day or so ago, about how entrepreneurs are choosing not to go public, because in some respects the question is "who in their

Imaged with Permission of N.Y.U. Journal of Law & Business

right mind would like to head a public company now or serve on a board of directors at this point in time?" The markets have changed so dramatically, when we talk about shareholders, were not talking about Antillean tennis shoes, who we used to talk about. Now we're talking about institutional investors who hold the vast, vast bulk of the equity in public companies and whose interests are very different from what we used to think about as the broad shareholder base. So, as these corporate governance "reforms" go forward—and I agree we're always fighting the last war, audit committees were the flavor of the month; and Sarbanes-Oxley compensation committees are this year's favorite target. What effect do you think we're going have going forward on these institutions? Are we turning them all into public utility?

Carol Bowie: I didn't see the Times article, but we've heard outcry before. Let me go back to your point about the institutional investors, who obviously do control a lot. They have huge interest in seeing corporate America thrive. Number one, the pension funds alone have incredible liabilities that they have to meet over the next 50 years or so, and they'll have trouble doing that because of the recent failures. So I wouldn't say that their interests are somehow contrary to a vibrant public corporate market—vibrant and successful. You can quibble or argue about what the impact of some of the changes may be, but I think again as John pointed out, if you really go in and look at it, we're not talking about overnight changing the face of corporate America. Even proxy access, which we haven't quite gotten to yet, is actually available at a handful of companies in the U.S. who have voluntarily or through shareholder action implemented that provision. But as far as I know, no one's actually used it. It's also very available outside the U.S. There are many markets that give shareholders access to nominate directors. We don't see those markets collapsing. So, I realize that, especially the ten in a row, it looks like incredible momentous change; and we've certainly seen a track record of unintended consequences of government action, no question about that—particularly on pay. But I don't know that we're on the precipice of the end of corporate America. Even those entrepreneurs who today may think "I'm better off private"—the time will probably come when their need for capital will perhaps overcome that.

Imaged with Permission of N.Y.U. Journal of Law & Business

Bill Allen: Why don't we turn to "say on pay", which we mentioned a couple of times, and then we'll turn to proxy access. Carol, "say on pay" was mandated with respect to firms that accepted certain government help in the crisis. What has been the experience with that?

Carol Bowie: Well, surprisingly, as you mentioned, all companies participating in TARP—the bailout program—were required to have advisory "say on pay" votes on their proxy ballots in 2009. In 2009 also, there were about 20 companies—a mix of companies—that had done it voluntarily for one reason or another, including RiskMetrics by the way. All of those proposals, those management say on pay proposals passed, most of them by pretty comfortable margin. The average level of support was I think around 88%. The lowest level of support was I believe 59% at a small bank—Bank of the Ozarks. To date, again, the demonstration is that shareholders are not going to be tossing rockets at companies over say on pay. They're looking for outliers, they're looking for egregious situations. That's certainly the case with RiskMetrics. We actually recommended support of about 80% of those proposals.

John Coates: There is one other place to look for learning on this, which is the UK. Which has adopted "say on pay" some time ago. . .

Jack Jacobs: And Australia too, right?

John Coates: Actually it's been adopted around the world: Norway, Sweden, the Netherlands. The UK in particular has been studied by some colleagues of mine at the Harvard Business School,[3] and they found, consistent with what Carol said, that it doesn't have a radical effect. Shareholders, by and large, vote in favor of what the management proposes in terms of compensation. But, there have been detectable, observable improvements in linking pay and performance, from before it was adopted. In particular at the companies that were the targets of withhold vote campaigns connected with "say on pay", they've shown the most improvements. So, modest, advi-

3. Fabrizio Ferri & David Maber, *Say on Pay Votes and CEO Compensation: Evidence from the UK*, Working Paper (2009), *available at* http://ssrn.com/abstract=1420394.

Imaged with Permission of N.Y.U. Journal of Law & Business

sory in the UK, as it would be here—it's not going to revolutionize the world, but the evidence suggests it would be a positive step.

Bill Allen: What has been the experience in the United States with the evolution of this on a private basis? I won't say a voluntary basis exactly, because people are being bludgeoned into accepting it, but they're being bludgeoned more or less regularly these days. I see Microsoft did one version of it a month or so ago. So, can you say what is the experience of what people have adopted "say on pay" voluntarily?

Carol Bowie: As you say, most of the time the volunteers adopting "say on pay" are doing so because they have received shareholder proposals that got, in most cases, majority support asking them to do so. They're responding to that, so it's not strictly voluntary, although it's not a mandate. As John mentioned we do have something of a track record in the UK that does show less "pay for failure."[4] This year actually, we saw the highest number of defeats in the UK. I think because for the first time since "say on pay" began to be used, which was May 2003 or 2004, the performance was actually going along pretty well, until a couple of years ago. So, again that's not surprising. It remains to be seen how it will play out overall.

Two benefits are often pointed to. One is more engagement between companies and shareholders on the issue of pay. That's what you hear the most about. I also, being someone who actually reads a lot of proxy statements, would say the companies that had "say on pay" on their ballots did a much better job than I've seen in the past—at least, than those who did not—in being informative about their pay programs. Not just how they work, few shareholders are really interested in too much of that, but what they want to know is: "Why are they there? What are they doing? How are they really helping to create value?" I think the point has been mentioned. The whole purpose of an incentive plan is to motivate behavior. Well, what behavior? The behavior, obviously, that is going to help accomplish the company's business strategy. It's amazing how many compensation, disclosure & analysis statements could go on for fifty pages and actually never get to that point.

4. *Say-on-Pay Effect Differs in UK, Netherlands*, P&I DAILY, Apr. 4, 2007, *available at* http://www.pionline.com/article/20070404/DAILY/70404017.

Imaged with Permission of N.Y.U. Journal of Law & Business

What is the purpose of this plan, and how is it creating value? I saw companies with "say on pay" do a much better job with that. So, the requirement to persuade shareholders, to really put it in terms that are going to make sense to them may actually have a beneficial effect, which is not the one you often hear about.

Jack Jacobs: Just a few points. This whole notion of an advisory shareholder vote is a strange animal, at least in American corporate law. In American corporate law there is no such thing as an advisory shareholder vote: if shareholders have the right to vote, then whatever they vote on becomes binding in some legal sense. So, this procedure would be a departure from what we are used to. The question that we all ask is, ok, should we worry? And what I am hearing is no, we shouldn't worry, because this is a good thing. You can look to the experience of the UK as an example. And that may be right. But I think it is also important to note that the UK corporate governance system is different from ours. The UK Company Law that was passed in 2006 reflects a much greater degree of shareholder empowerment in the governance of the corporation and the changes to the board than normally occur under the American corporate law system, particularly that of Delaware. But the reality is, even though the say on pay vote would be advisory, it would clearly have an impact from a public relations point of view. That is, the advisory vote is designed to mold the behavior of compensation committees. Directors charged with formulating pay packages cannot avoid being affected, because whatever they do will get an up or down vote with all of the good or bad publicity consequences that come with it. And in that regard, I see no functional difference between a Congressional say on pay requirement and an SEC requirement to disclose what the company is proposing and why they are proposing it. That is, I think the effect on board behavior would be precisely the same.

John Coates: I think actually there is a difference, Jack, and it's this: a company that has its shareholders approve, by a significant margin, its compensation disclosures, can then say truthfully, "We have gone to our shareholder base and they agree with us; this is a good package." Whereas, if you just have disclosure you don't have that confidence, you don't have that ability. So, I agree with your fundamental point that

Imaged with Permission of N.Y.U. Journal of Law & Business

it is not totally innocuous. It's not as if this is going to have no effect, otherwise what's the point? But, I do think that the combination of an advisory vote with disclosure, along the lines that Carol was suggesting, will improve, and frankly I think the shareholder community needs as much education here as the boards do. This is basically saying you have to have this dialogue, and I think that dialogue will be good in the long run.

Stephen Lamb: Let me add one thing, which is that up to this point, the New York Stock Exchange has not changed Rule 452 to prevent broker discretionary voting on say on pay proposals, which they have done in the case of director elections. They have now changed the rule, saying that even in an uncontested election, brokers—and this covers basically every broker in the United States, whether one is dealing with U.S. companies or foreign companies—can no longer vote shares without explicit directions from the customer. And I know there has been suggestion and some pressure on the exchange that they should now amend Rule 452 to eliminate discretionary voting with respect to say on pay proposals, even though they are pretty much routine business. So, if that were to come to pass, and I think the sort of cheery reporting about how 88% of those people voting have voted in favor, and so on and so forth, would be dramatically different.

The absence of broker discretionary voting, would also dramatically increase the power of entities of firms like Carol's firm, RiskMetrics, and the other proxy advisory firms. Carol, I've been to your website and looked at the 2010 program, and there is an awful lot in there on compensation, and there is a great deal in there on. . .

Carol Bowie: But it's not new.

Stephen Lamb: It very much focuses on what will happen in the case of a company where there is a say on pay that is defeated, and what will next year bring for the members of the compensation committee if they don't adequately, in your judgment, respond to that defeat. And then, the following year, if there still isn't some adequate response, what will happen to the whole board. And in that case, we are then dealing with director elections, which also brokers cannot vote on. So there is the potential here to very much change the landscape.

Imaged with Permission of N.Y.U. Journal of Law & Business

Carol Bowie: Well, let me give you some comfort though, because in actual fact, the policy has not really changed at all. We reorganized it to make it a little more rational in light of say on pay, but in fact, RiskMetrics policy, has been, for a number of years, to do a full blown evaluation of executive compensation. If there were concerns that rose to a certain level, the outcome of that would be a recommendation to withhold, or in rare cases, vote against members of the compensation committee, as a result. What say on pay has done is inserted an interim communication mechanism, that's all. So this is not a new policy.

Stephen Lamb: I would suggest to anyone who is serving on, or thinks about serving on a compensation committee to go look at that recitation on your website, because it is daunting.

Carol Bowie: But please look at last year's as well.

Stephen Lamb: And there is a very long list of things that you take into account without any real weighting. You say you made it a little more rational, well that's comforting.

Jack Jacobs: Let's talk for a minute about communication, because there is actually another layer of communication that we haven't really addressed, which is this: my friends in the UK tell me that what really happens as a result of their say on pay policy, is that the executives, or the head director of the board, does an informal canvass with their major institutional investors and runs by them, before there is any say on pay vote, what the package proposal will be. So, there is that kind of informal communication which, in most cases, makes the formal say on pay vote essentially an academic issue. The question is, is that the sort of activity we want our compensation committee members and board representatives to be engaging in?

Bill Allen: Let me jump in, because I think, number one, American boards cannot resist say on pay. The flow is in one direction on this. ISS is backing it, all the institutions are backing it. So you see companies doing things like Microsoft does every three years, or some people do it every two years, because they are trying to mediate getting a little breathing space, because they know, that they really can't resist it. Personally I have a hard time getting too exercised about it, but

Imaged with Permission of N.Y.U. Journal of Law & Business

on the other hand, I do see RiskMetrics, as becoming more and more the central communication mechanism for all of these institutional investors. The voice of the institutional investors is all the corporate governance specialists inside and not the investment function of the institutional investment. And, Carol, your company is going to end up having tremendous power, and sooner or later everybody that has power is called to account for it. So, there's going to be some, you know Congress is going to. . .

Carol Bowie: I haven't heard that before—that we will get that powerful.

[Laughter]

Bill Allen: In time. Well, I think it is pretty obvious.

Carol Bowie: I couldn't argue the point that it *appears* to be pretty obvious. Being on the inside, as it were, I do know that there are a lot of limits to that. I'll just raise a couple of points. Most of the votes that flow through our system are under what are known as customized policies. All of the big voting institutions have their own voting policies. They do not follow RiskMetrics's advice in lock-step by any stretch of the imagination. I think even the studies that are most critical claim, at most, twenty percent of votes that are quote-unquote swung by ISS/RiskMetrics. Beyond that though, a point that I do like to make and I feel that I can make it because I wasn't born and bred at ISS, I actually came into the company when they acquired a neutral non-recommendation providing advisory service IRRC, so I came in with a fair amount of skepticism. What I've seen, and I've seen it increase, is that the RiskMetrics policy, including the compensation policy, is very much informed by clients, by institutional investors, as well as other market players. There is a lot of outreach to issuers as well, on virtually all of the policy changes. So, you know, you could conclude reasonably from that, I think, that sometimes it's not a coincidence that the RiskMetrics recommendation happens to be the same voting direction as many other investors take because they are very much aligned; that's the whole purpose of the policy development process. In terms of the power, there is no way to deny that. It's a competitive industry. It's an open industry. And what we are most interested in providing, certainly from my vantage point, are comprehensive

Imaged with Permission of N.Y.U. Journal of Law & Business

and accurate research reports. And our clients tell us all the time that that is what they are interested in, so that is what we endeavor to do.

Stephen Lamb: But Carol, I assume you're right, it's an open industry, but it's essentially a closed market, in the sense that because of a letter written by the Department of Labor twenty years ago or thirty years ago, that said institutional investors have a fiduciary duty to vote shares they own. They now all have to vote the stock and most of them either don't want to or don't have the resources to figure out how to vote 2000 or 5000 different proxies every year, so they have to rely on people like you to do it.

Carol Bowie: For information. They don't have to rely on us to tell them how to vote. In fact, it is their fiduciary duty to determine how to vote in the best interest of their owners.

Stephen Lamb: Of course. So, you enter into these structured policies with them, but at the end of the day, how many proxies do you actually deliver?

Carol Bowie: How many proxy reports do we deliver?

Stephen Lamb: No, no, proxies.

Bill Allen: She said twenty percent of the vote.

Carol Bowie: Not me. That is not our number. That is the most I've seen from so-called studies. I don't even know how anyone would figure it out to be honest.

Stephen Lamb: Maybe I am misinformed about this, but I have heard from other people in the same business you are in that when they make a recommendation, they inform their client as to what the recommendation is and then they transmit the proxy, unless the client writes back and says "No, I don't want to vote that way." They communicate with Broadridge, or whomever it is, about how those shares will be voted.

Carol Bowie: If you are talking about the mechanics of the vote transmission and the determinations, yes. All clients at the end of the day, again, have a fiduciary duty to be informed about the way they are voting. When they sign onto the policy that is what they are doing.

In fact, in speaking with a couple people before the panel, this is the big challenge: how to adhere to the policy that cli-

Imaged with Permission of N.Y.U. Journal of Law & Business

ents have signed onto, but still be able to deal with each company on its own terms, but maintain some consistency in applying that policy. But in any case, I think we are veering off.

Bill Allen: Veering isn't so bad. We've got one or two questions and then, we've alluded to proxy access so far and we only have 15-20 minutes left.

AUDIENCE QUESTION: You've touched again on the issue of compensation, and I'm curious in going back to a comment that was made, why would there be a rule that the board would be involved with compensation of the lower level employees, such as the person working on the rig, and without being burdened by knowledge, is it too naïve to think it might bring a dose of reality to the board of what actually is paid for the actual work of the corporation and that perhaps someone can be brought into senior management for the pitiful sum of seven figures salary?

Bill Allen: Some might think the answer is yes.

John Coates: Boards are totally aware of pay disparities. I would bet you that if you took a poll of many board members they would not like the overall divergence of wealth in our country. The point I was making earlier is not awareness of the difference of pay within an organization like Exxon, but where you want the board spending its time, focusing on the details of the pay structure for any given level of the organization. And whether it makes sense to mandate across the board for all companies that the board do that. The broader issue of pay disparities extends well beyond public companies. My good friend here earns a lot more pie at Wachtell on average. . .

Ted Mirvis: That's enough.

John Coates: . . .then he did when I left and if I could buy back in for at least a year, I'd be happy to do that today because the pay differentials between 1980 and today for lawyers, investment bankers, hedge fund managers, go across the board. Wall Street has tracked just as rapid an increase, not just in the publicly held big financial companies, but in privately held organizations too.

Bill Allen: The private firms are much higher paid. If you look at the hedge funds, for example, those people do not

Imaged with Permission of N.Y.U. Journal of Law & Business

want to disclose what they make. They really resist it. There was one more question in the back.

AUDIENCE QUESTION: We began this discussion with the comment by Professor Coates that there were only a handful of institutions responsible for the problems that we face. We then morphed into discussions about the responsibility of the regulators, the responsibility of corporate governance, the compensation packages. My question is how do we prevent in the future a handful of institutions bringing the rest of us to our knees?

Bill Allen: That, I think, is the next panel.

[Laughter]

I was very encouraged by the fact that the President seems to be listening to Paul Volker. Number one, the difference between regulating the banking industry and what has become called the shadow banking industry—that is, the unregulated hedge funds and investment pools—somebody has to look at that. There has to be more regulation of it. But why we cannot get into a world in which we have financial institutions that collect deposits, make loans, and do what commercial banks used to do, and have the trading and the creation of derivates and so forth in other institutions. I don't understand.

AUDIENCE QUESTION: Can Professor Coates respond to what Professor Fried said in his keynote address?

John Coates: To the question about how to prevent the next crisis. So, I agree with what Bill was just saying about the administration's current set of proposals. I actually tend to think mandatory separation—going back to Glass Steagall—is a bad idea because I think it would be much better to create powerful incentives by ratcheting up the capital requirements and then letting the organizations themselves decide how to bring down the scale and scope of their enterprises. I think that would be more efficient in the long run than having government effectively come in and draw the boundaries, because one of the things that Bill alluded to earlier was the last time we did that, in 1933, it didn't actually take an act of Congress for that all to erode. The reason it eroded was partly global competition, so they're going to move to Dubai and do what we don't want them to do here, and second because lawyers, like Ted and his buddies, and me when I worked at Wachtell,

Imaged with Permission of N.Y.U. Journal of Law & Business

are very good at finding ways around the rules that Congress tries to lay down. I think it would be simpler, in effect, to tax size and complexity through the capital system and then let the private organizations figure out how to respond to that. Nobody's electing me yet, though.

AUDIENCE QUESTION: I have a two-part question. One is, I question whether or not say-on-pay will actually work within the trading climate we have now, because it seems like 20 or 30 years ago, investors held shares for 5 or 10 years. Now, the vast majority of investors, from my perspective, are holding shares for less than a year, sometimes even a week or a day. So, I wonder whether there are any statistics as to the percentage of shareholders, not shares, but actual shareholders, who vote in these proxy contests or these annual meetings.

The second question is, on the one hand it seems that we have Congress, from the perspective of corporations, imposing these Draconian rules that are pretty ad hoc, and on the other hand we have corporations who are saying we don't need any rules. In fact, we need even less regulations. So, to what extent are corporations actually—besides the issue of using lobbyists—to what extent do corporations come together and say "Let's analyze the issues, and come up with a regulatory structure that we can all live with that would in fact address some of these concerns that the vast majority of Americans have?"

Bill Allen: So I take it that the second part of the question is, does the business roundtable lobby its positions with respect to corporate governance, at the SEC or Dodd? I actually have no real information, but I imagine they do.

Carol Bowie: I think you're right.

Stephen Lamb: I thought the question really was, "Do they spend time and resources in trying to figure out what the right answer is, rather than lobbying against someone else's proposal?" And the answer to that is "Probably no." But I wouldn't criticize them for that, because the people making the proposals have done nothing to do studies and to actually come up with any reasoned basis to support the proposals that are being made. So, I wouldn't blame the business community. Perhaps I should, because studies are needed to show that the proposals being made do or do not have value.

Imaged with Permission of N.Y.U. Journal of Law & Business

Carol Bowie: Proxy access is a great example of a concept that has been around for many years, maybe 70, and was really fought, quite vociferously by issuers, the whole notion of what's now being embraced by them as private ordering of proxy access. As recently as a few years ago, issuers, and certainly the Business Roundtable, were lobbying the SEC to restrict shareholder proposals seeking proxy access. Now that there's the specter of a federal mandate, they are advocating for private ordering.

Stephen Lamb: They were successful about that. The SEC changed its own rules in a way that prohibited shareholders from doing that.

Carol Bowie: Certainly, to the enthusiasm of the issuers.

Stephen Lamb: Sure, sure.

Bill Allen: Time, time! I approve very much this active interaction. But we ought to note one thing. Corporate governance at this level of new rule formation is a political contest among people who see their interests one way or the other. Now, one question that academics may have is "Are their interests—or at least their perception of interests—consistent with the public interest?" But I don't think we can quarrel or criticize the fact that the business resisted this and now is doing private ordering because it looks inevitable. And that's just the way the process works. But let us talk about the merits of it as a substantive matter. Now, can somebody briefly summarize the proposal on proxy access, talk about the likelihood of its being enacted, and talk about its likely consequences? Are we over our time? Okay, that's what we want to do next year apparently.

[Laughter] I apologize to the panel and the audience for not getting to the all the important topics. I do want to thank the panel for a lively, expert and enjoyable panel. Thank you. It was very enjoyable.

Imaged with Permission of N.Y.U. Journal of Law & Business