

# Report of the American Academy's Corporate Responsibility Steering Committee

The early years of the new century have been plagued by major scandals at Enron and WorldCom, by numerous instances of overly aggressive accounting and excessive executive compensation, by compromised auditors and securities analysts, by inattentive boards of directors, and by self-indulgent mutual fund managers. Public confidence in American business and finance has been shaken to a degree not seen since the Great Depression. Just as the Depression ushered in a period of intense reform, recent scandals have produced the Sarbanes-Oxley Act of 2002, new rules at the stock exchanges, a more vigilant Securities and Exchange Commission, and reenergized state attorneys general.

*Restoring Trust in American Business*, the first publication of the American Academy's Corporate Responsibility project, brings together leading scholars and practitioners with diverse views to reflect more broadly on how the collapse occurred and suggest productive strategies for change. The American business community must do more to restore badly eroded investor and public trust. The legislative and regulatory response to date, as well as the bulk of commentary, has focused on the relationships among senior managers, the board of directors, and shareholders; on accounting and audit practice; on executive compensation; and on rules regarding the board, its composition, and its relationship with the firm's auditors.

To be sure, the principal responsibility for corporate misconduct, when it occurs, rests with corporate management and

boards of directors; and the restoration of trust in American business will require of CEOs and boards an increased commitment to the larger society and to the stewardship of the corporate institution. However, recent governance failures are not limited to management and boards. They extend well beyond the boundaries of the corporation, suggesting that the supporting institutions outside the boardroom also need attention. This report focuses on how these supporting institutions can play a more constructive role in shaping corporate conduct.

### THE FAILURE OF THE *GATEKEEPERS*

The American market-oriented system relies primarily on marketplace actors and private gatekeepers to check and warranty corporate conduct. Certainly, governmental regulators (including quasi-public, self-regulatory organizations with regulatory roles, such as the stock exchanges) deter and punish corporate wrongdoing with the “stick” of rule enforcement; and better rules or stronger enforcement might have prevented more of the corporate malfeasance. But the regulatory stick is a blunt instrument. Moreover, our political process renders regulatory agencies vulnerable to private actors’ efforts to diminish their funding and weaken their oversight capabilities.

Clearly, the regulators did not prevent the recent wave of corporate malfeasance; nor did companies’ boards of directors; nor did their auditors, lawyers and investment bankers; nor did the business press. Each group had some opportunity—and some, an explicit professional obligation—to constrain corporate management, and to safeguard the public’s trust in business and in our capitalist system. Yet each of these groups got caught up in powerful market pressures that undermined their commitment to “doing the right thing,” whether for clients, the general public, or both. The failure was exceptionally pronounced during the long-running bull market of the 1990s. During that time, a culture of greed compromised professionalism and produced rampant conflicts of interest on the part of professional service providers.

For more than a century, an invaluable centerpiece of the American economy has been our large public securities markets, through which the public directly and indirectly invests its capital in corporations. In spite of occasional failures, these capital markets have been perceived, both by U.S. investors and by individuals and governments around the world, as basically transparent and honest. These markets constitute important national assets. The businesses that have been financed through them have brought the benefits of science and technology to consumers throughout the world, raising the American—and the global—standard of living. But this success story was not inevitable; it has depended upon an infrastructure of law, regulation and enforcement, and on a network of supporting institutions that promote public trust.

Among the most important of these supporting institutions are those we refer to in this volume as the *gatekeepers*. These *gatekeepers* include lawyers, accountants and journalists, as well as corporate directors, regulators and investment bankers. While these occupations are not all viewed as full-fledged professions, each performs a vital function in facilitating the production of wealth in a fair and efficient way.<sup>1</sup> What all of these *gatekeeper* groups have in common is that the public expects them to discharge their responsibilities with integrity, and—more explicitly in the case of the recognized professions—to foster the public good. The failure of this network of *gatekeepers* was a recurring theme in the business scandals. In too many instances, the *gatekeepers* in pursuit of their own financial self-interest compromised the values and standards of their professions. Had managers always acted with integrity, the *gatekeepers*' failures would not have been so costly. The *gatekeepers* are expected to constrain the primary corporate actors—America's managers—from acting badly. In the most recent round of corporate scandals, the first tier—the managers—failed; and then the *gatekeepers* failed as well.

<sup>1</sup> The essay in this volume titled “Management as a Profession” enumerates several criteria that collectively define a “profession.” These include a common body of knowledge, member certification and licensing, a code of ethics and sanctioning mechanism, and an explicit commitment to the public good.

It is now apparent that there has been a systematic decline in the status and role of America's professions, including those to which business firms have traditionally looked for counsel and judgment. In the intensely market-driven economy of the 1980s and 1990s, many professionals ceased to be trusted advisors and sound counselors, capable of appropriately mediating among the short-run and long-term interests of business firms and the larger interests of society. Instead, they came to view their role as simply advancing management's interests. The result is the troubling number of professional advisors who failed to do their part in preventing the corporate scandals. The number and magnitude of corporate wrongdoing cases would have been almost inconceivable had these professionals behaved consistently with their traditional roles and the public's legitimate expectations.

#### REBUILDING PROFESSIONALISM FOR THE TWENTY-FIRST CENTURY

As a society, we face the challenge of rebuilding professional standards in a world of interdependent markets that are more global and more powerful than ever before. These markets have grown to the point where they dominate the structures that were invented, in another era, to channel their energies productively. Market participants have also changed radically; investors have become global, larger, more diverse in their goals, and more anonymous than ever before.

In this enormously complex and fluid environment, responsible corporate conduct depends on public spirited *gatekeepers* exercising independent professional judgment. *Gatekeepers* cannot perform their vital functions if they are reduced to mere facilitators of management or captives of short-term market forces.

It is time to reimagine and rebuild these *gatekeeper* roles in order to empower them to more constructively shape corporate conduct. It is also time to give more serious thought to the scope of the public obligations of corporate management beyond simple compliance with the law.

The recommendations that follow emerge from a series of workshops and discussions convened by the American Academy's Corporate Responsibility project. We begin with several recommendations for stronger boards of directors, but focus as well on the other *gatekeeper* roles. We have also included some thoughts on institutional shareholders, and the need for ongoing professional education. The recommendations propose a direction for action, and also represent an effort to stimulate further conversation. What is more important than any specific recommendation is the realization that the challenge of restoring trust in American business will continue to require the urgent attention and cooperative efforts of our nation's intellectual, business, and public leaders.

# Recommendations for Practice

## RECOMMENDATIONS FOR DIRECTORS

■ **Oversight Role.** In recent years there have been a number of high-profile failures of public company boards. Some Committee members see these failures as exceptions within a broader pattern of improved board performance over the past decade, while others point to data on misleading financial reporting and excessive executive compensation as evidence, among other things, that these failures arise out of a general culture of board passivity. Committee members agree, however, that the standard of performance in American boardrooms must be raised. Moreover, the debate sparked by recent high-profile failures points to the need to clarify the role of boards in public corporations. The primary role that the American corporate governance system has assigned to the board is to set and oversee the company's direction, and to appoint, oversee, compensate and, where appropriate, replace management. The board also gives advice and makes several important kinds of decisions, including approving the company's strategy. The board has ultimate legal responsibility for the company, and is the primary "gatekeeper" for ensuring that operating managers act with integrity and competence. But it cannot as a practical matter, and should not, attempt to run the company on a day-to-day basis; it must delegate this responsibility to management. The board is responsible for having monitoring systems in place to help ensure that the firm is running well.

■ **Corporate Ethics.** Directors have oversight responsibility for the legal and ethical conduct of the corporation. Boards must therefore ensure that companies have appropriate ethics policies and compliance systems. On a day-to-day basis, however, a com-

pany's ethical tone is set by top management, and in particular the CEO. Boards must therefore give as much consideration to the integrity and ethical standards of CEOs (and CEO candidates) and other senior management as to their business competence.

■ **Professional Standards.** Although corporate directors are not now usually viewed as comprising a “profession,” the members of the director community should bring a spirit of professionalism to their responsibilities. Directors should view themselves as trustees of the interests of shareholders and the corporation. For most companies, these interests will properly be construed as the shareholders’ and the corporate institution’s *long-term* interests, although there are also circumstances in which directors are obligated to consider more short-term interests as well. In order to fulfill their obligations, board members must devote sufficient time and effort to performing their duties, including being adequately informed about the company’s affairs.

■ **Independent Leadership.** The Committee endorses the continuing trend in favor of boards composed of a majority of directors who are independent of management and have no material interests which conflict with their responsibilities as directors. The independent directors’ effectiveness is greatly enhanced by having a leader who is also independent of management. It is appropriate for each board to determine, in light of all relevant circumstances, whether that independent leadership is best provided by a non-executive chairman of the board, or by designating and empowering a “lead” or “presiding” director. Regardless of the chosen structure, the independent directors should meet on a regular basis without management.

■ **Executive Compensation.** Boards and their compensation committees should structure the CEO’s compensation to reflect the shareholders’ and corporation’s long-term interests. In setting the compensation of top executives, directors must take into account employment market conditions and the need to

motivate and retain talented individuals, as well as what is acceptable to shareholders. But they should also be mindful of the corporate sector's collective interest in maintaining public support and confidence in business, and the impact that extravagant compensation terms—particularly terms that do not seem to correlate well with performance—have had on undermining that support and confidence. A set of “best practice” principles that would better tie compensation to long-term performance would be welcome.

■ **Shareholder Input in Director Nominations.** The Committee acknowledges a diversity of opinion among its members regarding the merits of the “shareholder access” proposed rule issued by the Securities and Exchange Commission. This proposed rule would permit shareholders meeting certain criteria, including certain triggering events, to nominate a “short slate” of director candidates directly on the company's proxy materials. Some members of the Committee support this proposed rule and others oppose it. However the SEC ultimately rules on this matter, the Committee agrees that the nominating/corporate governance committees responsible for nominating candidates for election to the board should be attentive to shareholders' concerns and preferences regarding nominees.

■ **Auditor Oversight and “Fair Presentation.”** The Committee applauds the assignment of the auditor oversight role under the Sarbanes-Oxley Act to the board via its audit committee. In performing this oversight role, audit committees should explicitly acknowledge that the “fair presentation” standard applicable to companies' financial disclosure goes beyond mere compliance with GAAP rules, and that it requires that the company provide a transparent view of its financial results and condition.



## RECOMMENDATIONS FOR INSTITUTIONAL SHAREHOLDERS

■ **Governance Responsibilities.** Institutional investors, and the firms that manage their funds, should acknowledge their duty to ensure that companies in their portfolios adopt good governance practices. They should also acknowledge their duty to actively review and vote upon proxy resolutions. To meet this objective, institutional investors should make reasoned, independent decisions on proxy votes. They should neither mechanically support company managements' positions, nor automatically follow the recommendations of proxy advisory services. While they may appropriately rely on expert advice in this area as in other areas, institutions should recognize that proxy voting is a fiduciary responsibility that ultimately lies with the institutional investor itself, and not with the advisor. Further, company managements and boards should be encouraged to focus on long-term strategic goals while also managing short-term market pressures.

■ **Governance Standards.** Institutional investors and investment management companies should adopt their own vigorous governance standards, adhering to their own fiduciary duties to those who invest money with them. As fiduciaries, institutional investors and investment management companies should scrupulously refrain from activities that subordinate the interests of their investors to other objectives.

## RECOMMENDATIONS FOR REGULATORS

■ **General Standards of Conduct.** Leaders of regulatory, self-regulatory and judicial bodies (including the Chairs of the Securities and Exchange Commission (SEC), the Public Company Accounting Oversight Board (PCAOB), and the National Association of Securities Dealers (NASD); the leaders of the stock exchanges; and the members of the Delaware court, among others) should actively use their "bully pulpits" to encourage the highest standards of conduct for corporate man-

agement, boards of directors, professional advisors, and those affiliated with their organizations.

■ **SEC Independence.** Congress must fully respect the SEC's status as an independent agency, and commit to funding levels for it that are adequate for the vigorous enforcement of laws and regulations. The SEC should vigilantly guard its independence against short-term political and budgetary pressures. Corporations and their lobbyists must refrain from seeking to starve the SEC of funding in the pursuit of their own narrow policy objectives.

■ **Investor Education.** The SEC Chair, among others, should speak publicly and aggressively to encourage managers and institutional shareholders, as well as other investors, to carefully attend to issues of disclosure, fiduciary responsibility and conflicts of interest that affect the value of their shares. Effective managerial, institutional, and investor education should be a priority of the SEC, along with enforcement, inspection and disclosure review.

■ **Stock Exchanges.** The stock exchanges should institute vigorous governance standards of their own, in light of their role in setting and monitoring the governance standards of listed companies. They should further consider what additional role they can play in fostering high quality, cost-effective corporate governance in listed firms.

## RECOMMENDATIONS FOR LAWYERS

■ **Professional Standards.** The legal profession as a whole, as well as individual law firms, must reflect thoughtfully and critically on why some members of the profession have strayed from the highest standards of professionalism. The failure of lawyers to prevent corporate misconduct suggests that they can become beholden to corporate management. Lawyers representing companies must understand that, while the corporate entity acts through its management, the ultimate "client" is the corpora-

tion. Lawyers must bear in mind their responsibilities to that ultimate client, even as they properly take direction from members of management. Moreover, beyond the duty business lawyers owe to the client, lawyers owe a further professional duty to represent the client in a manner that is consistent with the public values elaborated below. Law firms must develop cultures that inculcate these duties in their members.

■ **Business Lawyers’ Duty of Independence.** The Committee urges leaders of the legal profession, as well as legal educators, to emphasize the need for business lawyers to act as *independent* legal counsel. The conception of lawyers as “zealous advocates” has long dominated the profession. This conception—which authorizes lawyers to adopt on their client’s behalf every advantageous construction of law that is not plainly erroneous—has social utility in the litigation context, where positions are tested by an informed adversary and evaluated by an expert and disinterested judge. But in the context of facilitating business transactions, where these judicial safeguards are initially absent, commitment to facilitating every advantageous transaction, unless no technically possible interpretation of the law can be found to support it, can lead to socially destructive action. Leadership of the legal profession should endorse, and include in statements of the professional obligations of business lawyers, the principle that such lawyers owe a public duty to the law itself, in addition to the loyalty and confidentiality that they owe to their clients. That public duty can be expressed as a duty to the discernible spirit that animates the positive law.

■ **“Up-the-Ladder” Reporting Obligation.** We applaud the SEC’s attorney professional conduct rule that requires lawyers to report a client’s material legal non-compliance, when they become aware of it in the course of a representation, “up the ladder” to the client corporation’s board of directors, if necessary; and that the lawyers withdraw from further representation of the client if the board fails to take timely steps to remedy the non-compliance.

■ **Lawyer Withdrawal Reporting Obligation.** The Committee acknowledges a diversity of opinion among its members regarding the merits of the “noisy withdrawal” proposed rule issued by the Securities and Exchange Commission. This proposed rule would require lawyers to report their withdrawal to the SEC, an obligation that would be in tension with the lawyer-client privilege. Some Committee members favor this “noisy withdrawal” obligation, while others do not. Even those Committee members opposed to a “noisy withdrawal” obligation agree that, at a minimum, the SEC should require the client company to report the lawyers’ withdrawal to the SEC, except where a committee of independent directors advised by independent counsel has determined that the withdrawing lawyers had not acted reasonably.

■ **Lawyer Independence and Compensation.** Lawyers and law firms must ensure that their fee arrangements with clients do not compromise their capacity to fulfill their duty of independence, and to conform to the highest professional standards. Various types of current fee arrangements have the potential for creating conflicts of interest or otherwise for impairing lawyer independence. Law firms should carefully scrutinize their policies concerning fee arrangements with clients to ensure that independence and professional standards are in no way compromised.

## RECOMMENDATIONS FOR AUDITORS

■ **Professional Standards.** The accounting profession must return to the high standards of professionalism it had in an earlier era, and must search for the reasons for its decline. Auditors play an indispensable role in regard to transparent financial reporting. The complicity of accounting professionals in cases of fraudulent or misleading financial reporting suggests that auditors, in some cases, failed to maintain appropriate independence from corporate management. The accounting profession must now fully embrace the legislative mandate that it is the board of directors—and its audit committee—that is the auditor’s “client.” Moreover, auditors of public companies owe a further profes-

sional duty to the investing public. The extreme concentration of public company auditors in a small number of firms may itself be problematic. Particularly in light of that concentration, it is critically important that each of these firms develops standards and a culture that serve to inculcate these obligations in its professionals.

■ **The Auditor Role.** The Committee endorses the mandate that accounting firms refocus on the audit function (while recognizing that many corporate clients continue to engage them for tax work as well). There remains, however, a need to clarify more precisely the scope of the audit function in regard to corporate misconduct risk and corporate business risk. This clarification will help to ensure that auditors are fully accountable for the function they undertake, but not subjected to unreasonable expectations beyond that function.

■ **“Fair Presentation.”** Auditors should embrace their responsibilities for the “fair presentation” of a company’s financial condition and results of operations; and should explicitly acknowledge that their responsibilities under this standard go beyond compliance with GAAP rules.

■ **Principles-Based Accounting.** The accounting profession is urged to move even further in the direction of a principles-based accounting regime, in order to minimize the opportunity for company financial disclosure that technically complies with rules while misleading the investing public. Bright lines are both constraints and safe harbors for companies and auditors. A move away from rules toward a principles-based system will, on the one hand, give companies and auditors greater flexibility in accurately portraying firms’ economic position; but, on the other hand, it will necessarily subject companies and auditors to greater scrutiny as to whether they did, in fact, accomplish this goal. While this move should benefit all concerned, it will require careful and thoughtful oversight by both the Financial Accounting Standards Boards and the Public Company Accounting Oversight Board.

## RECOMMENDATIONS FOR INVESTMENT BANKERS

■ **Professional Standards.** Investment banking has been transformed in recent decades. The traditional role of the investment banker as a company's long-term, "senior advisor" has become overwhelmed by a more transaction-based business. Unlike law or accounting, investment banking is not viewed presently as a "profession." It is, however, composed of highly skilled and well-compensated practitioners who (among other things) advise clients about major decisions that impact the investing public. More broadly, investment banking has become an important sector of the economy, both as a stand-alone industry and in terms of its great influence on the corporate sector. Investment bankers engaged by companies must understand that, while the corporate entity acts through its management, the ultimate "client" is the corporation. Investment bankers also must bear in mind their responsibilities to that ultimate client, even as they properly take direction from members of management. Moreover, in addition to the duty they owe to the client, investment banking firms should reflect on the nature of the obligations they may owe to the larger investing public in the performance of their various functions, beyond complying with the law. They should collaborate to establish a uniform code of conduct that articulates their obligations to clients and to the investing public. They should also establish formal training modules to teach appropriate guidelines and conduct to their professional staff. These steps toward professionalization could serve as a model for other sectors in the financial services industry that have been similarly transformed in recent decades (including, without limitation, the mutual funds and commercial banking businesses).

■ **Managing Conflicts of Interest.** The investment banking industry has been prone to conflicts of interest, partly reflecting its broad range of interrelated service offerings. These include the well-documented conflict between securities underwriting and investment research, as well as the potential for conflict between investment banking and commercial lending activities.

Independently of any regulatory initiatives in this area, investment banks should reflect carefully on the potential for conflicts created by their multiple businesses. They should disclose, to clients and to the public, these potential conflicts and the policies in place for managing them. A key priority should be to ensure that equity analysts perform and report independent, unbiased, and non-self-serving assessments of the companies they follow; and to ensure the economic viability of independent equity research.

## RECOMMENDATIONS FOR JOURNALISTS

### ■ **Business Reporting Mission and Professional Standards.**

The press is expected to play a critically important “watchdog” and informational role in a democracy, a role that extends to the world of business. Media firms must clarify and publicly articulate their mission regarding business reporting and develop appropriate standards of professionalism and codes of conduct for journalists who cover business. These missions and standards should include a commitment to traditional “Fourth Estate” values—including independence and objectivity—which should never be compromised by media firms’ own profit pressures.

■ **Greater Objectivity.** Journalists have a professional and public duty to report objectively and accurately on business. Business desk editors and individual journalists should be wary of the risk of losing objectivity and getting caught up in current emotions. It appears that this tendency has caused some journalists to “cheerlead” during bull markets, and to presume corporate guilt in the post-scandal environment. Outside the editorial pages, business journalists must be scrupulously independent and objective. They should bring open minds to the stories they cover and strive for the greatest possible accuracy in their factual reporting.

■ **Legislator Conflicts of Interest.** The press can make an important contribution to the functioning of the corporate governance system by increasing transparency where relationships are otherwise opaque. In that regard, the Committee urges that,

in the course of covering pending legislation, the press systematically disclose legislators' conflicts of interests where they have received campaign contributions from parties whose interests are directly affected. Moreover, the press should be alert to how private actors in our market economy can influence the legislature to reduce the funding of those responsible for regulating those private actors.

## RECOMMENDATIONS FOR PROFESSIONAL AND CONTINUING EDUCATION

■ **Professional Education.** The “teaching” of ethical conduct should take place at every level of education, as well as within each profession and each firm. Within this broader context, professional schools play a key role. Beyond a single course in ethics, professional schools should consider incorporating ethical standards modules throughout the curriculum, which should include case studies that highlight both ethical and unethical conduct. Among other things, they should examine how business structures can provide incentives (and eliminate disincentives) for managers to act ethically. Professional schools should closely examine their curricula in this regard. The various professions should also develop appropriate ethics curricula for the continuing education of their members.

■ **Education Within the Firm.** The leadership of individual firms should also take steps to ensure that the firm has a culture of ethical conduct, and to mitigate against the explicit and implicit pressures for better performance that can undercut ethical standards. The ethical standards of the firm should be explicitly discussed and taught to professional staff *in situ*, in addition to the ethics training received outside the firm. These efforts are particularly important in regard to the emerging professions.