U.S. Securities and Exchange Commissic

Speech by SEC Commissioner: "Corporate Governance in the United States" Remarks before the ECGI/ALI 2006 Transatlantic Corporate Governance Conference

by

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U.S. Securities and Exchange Commission

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Thank you, Michael. It is a pleasure to participate in the 2006 Transatlantic Corporate Governance Conference. I would like to thank Alex Schaub of the European Commission for inviting me. I have had several opportunities to meet with Alex and Charlie McCreevy to share our views on subjects of mutual interest regarding the capital markets. We at the SEC value our relationship with the EU and look forward to continuing our high quality dialogue. We very much appreciate the mutual good will. On a personal level, I would like to extend best wishes to Alex on his retirement and note that I am leaving the SEC next month, as well. I don't know what Alex's immediate plans are, but my short-term plan includes hiring a personal trainer, tennis, swimming, golf and yoga. In between those activities, I will be deciding what my longer-term next step will be. But, turning to the business at hand, before I go any further, I need to give the SEC's standard disclaimer. The views I express here today are my own and do not necessarily represent the views of the Commission, any of the other Commissioners or the SEC staff.

Your conference organizers have chosen a very important and timely topic, corporate governance and the role of controlling shareholders. Corporate governance issues are universal, but today, I would like to give you a U.S. perspective on issues relating to the conference topic. Earlier speakers focused very specifically on the U.S. treatment of controlling shareholders. I would like to take a step back and discuss corporate governance in the U.S. more generally - to put the earlier discussions in context and to highlight some of the corporate governance issues that the SEC has been facing in the aftermath of the Enron and WorldCom scandals, which resulted in the passage of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), the most significant corporate governance legislation passed in generations.

In the U.S., management, the board of directors and the shareholders form a corporate decision-making hierarchy. Management is at the bottom of the hierarchy. Though some CEOs don't always seem to realize this, it's true. Nevertheless, management gets to make the vast majority of the decisions. Everything from business strategy and its implementation down to the color of the wallpaper in the office hallways is the province of management. Management's responsibility, and it's a big one, is the day-to-day running

of the corporation.

The board of directors is next in the hierarchy. In the U.S., the board of directors has a broad mandate to direct management, to preserve the corporation's assets and to safeguard the interests of the shareholders. The board has two broad fiduciary duties to the corporation -- the duties of care and loyalty. The duty of care requires that in carrying out their duties, board members exercise the same care that an ordinary, prudent person would exercise in similar situations under similar circumstances. The duty of loyalty requires board members to act in good faith and in the best interests of the corporation. Importantly, the board owes these duties to the shareholders - not the corporation's management, employees or customers. Even for companies with controlling shareholders, these duties apply to all shareholders, not just the majority shareholders. The board must be mindful of these duties as it goes about its business of, among other things, selecting a chief executive and determining that person's compensation, deciding whether or not to declare dividends, approving the issuance of securities, and recommending or discouraging certain action by the shareholders, such as approval of merger or acquisition proposals. The board may delegate some of its functions to board committees - such as audit or compensation committees - that are made up of a subset of the board members.

At the top of the hierarchy are the shareholders. In the U.S., generally, shareholders have a say on the most important corporate matters, such as electing directors or amending the corporation's charter. They also vote on whether or not to authorize issuing securities or approve the sale of substantially all of the corporation's assets, as well as significant mergers and acquisitions.

In the U.S., the laws and rules that establish this hierarchy emanate almost entirely from each of the 50 state governments and their respective courts of law, and to a lesser extent, the securities exchanges. While the state requirements vary from state to state, in general, they are similar. Also, they provide some flexibility. Most states allow corporations latitude in establishing at least some specific corporate governance provisions, which the corporations articulate in their respective charters and bylaws. These provisions relate to such matters as the election of directors or the authorization and designation of classes of securities, including, for example, preferred versus common stock and securities with different voting rights. Securities exchanges typically impose their requirements through listing standards. For example, the NYSE generally requires that a majority of each listed company's directors must be independent. Simply put, state corporate law and exchange listing requirements provide the substance of what companies have to do regarding governance.

So what is the SEC's role regarding corporate governance? We do not, generally, tell companies what to do, particularly historically speaking. When it comes to public companies, the SEC is primarily concerned that companies tell investors what they do, by requiring full, fair and accurate disclosure of material information about their businesses, financial condition and operating results. With certain limited exceptions, the SEC's rules do not impose substantive corporate governance requirements on issuers, but rather require only disclosure. The management, board and shareholders can do whatever is permissible under the appropriate state laws and exchange listing requirements, so long as they tell investors what they are doing. If management changes the company's business strategy and the nature of its operations, that's fine, as long as the company complies with the law and investors are told of the changes. If the board wants to pay the

chief executive officer a large salary, the SEC will not object, provided it is disclosed. However, when doing so, the board has to keep in mind those duties of care and loyalty I mentioned earlier that derive from state law, not the SEC's rules. In particular, the rules regarding controlling shareholders are generally the province of the states.

The SEC's disclosure rules complement state law and exchange listing requirements. First, management and the board have to be mindful of the disclosure rules in carrying out their corporate functions. For example, when they enter into a corporate transaction with a related party, such as a controlling shareholder, director or executive officer, they know, or they should know, that they may have to provide disclosure about the terms of the transaction for the world to see. Sunlight is indeed the best disinfectant, and disclosure requirements may often discourage self-dealing and encourage better governance. Second, the SEC disclosure rules are designed to work in tandem with the more substantive state law and listing requirements of the exchanges. Many of our disclosure rules reference state corporate law and require disclosure concerning what that law is, and how that law applies to the company. Third, the system is premised on choice -- namely, letting shareholders, who are the owners of the enterprise, make informed voting decisions. This includes what is, for shareholders, the most important choice of all -- deciding whether to buy, sell or hold their securities.

While each of the three constituencies shares many of the same aims for the corporation, they don't always agree on all matters, and there are sometimes conflicts of interest. What benefits management may not always be in the best interests of shareholders, large or small. As I said previously, the board is responsible for directing management in the context of its fiduciary duties to the corporation and its shareholders. But, different shareholders may have different interests, depending upon their circumstances. These potential conflicts are compounded by the fact that, at many public companies, specific persons may be members of more than one constituency. Some managers and large shareholders may also be board members. Especially in smaller companies, one or more persons may be members of each of the three constituencies. This is particularly the case when there is a controlling shareholder.

Not only do the three constituencies have different aims and perspectives, but they are also subject to differing market and regulatory dynamics and trends. Focusing first on management, while I believe that the vast majority of executive officers of public companies are hardworking, honest, and capable, and act in the best interests of their shareholders, there have been some terrible frauds perpetrated. In the U.S., we had Enron, Worldcom and others. Here in Europe, you had Parmalat, Royal Ahold and others. As a result of these frauds, management has been more closely scrutinized over the past several years.

In addition, management compensation and incentives have been the subject of intense public debate. Boards and executives have been criticized as the level of executive compensation has risen dramatically when compared to the pay of the average worker. Stock option grants to executives have also come under fire. Once thought to align shareholder and management interests, it has become apparent that they may encourage unintended behavior, since option holders and holders of underlying equity securities may have different economic interests. In addition, we are hearing that some companies may have "backdated" stock option awards, so that the exercise price was lower than the underlying stock price on the actual grant date, without providing accurate disclosure

regarding, and properly expensing, the grants.

Regarding boards, the trend in the U.S. has been a push for greater independence to help mitigate the conflicts. This push started in the 1970s, and throughout the rest of the 20th century, we moved gradually towards mandating greater independence on boards of directors to oversee management, foster integrity and prevent malfeasance. The corporate scandals that occurred in the early years of this decade hastened the push for more board independence. Sarbanes-Oxley imposed new independence obligations and restrictions on public company directors. Board audit committees have become more independent and established new oversight-related procedures. In recent years, many of the stock exchanges have changed their listing standards to require more board independence. Of particular note to this audience, listing standards generally include explicit exceptions to these independence requirements for situations in which a single entity or group of controlling shareholders owns specified large percentages of the company's stock.

I have been concerned for some time that increased director independence is often assumed to be the panacea that will prevent future misconduct - or even managerial inefficiency. Over the past three decades, however, heightened board independence has not prevented subsequent crises, and the evidence is inconclusive regarding whether there is a correlation between independence and performance. Yet, each time a crisis erupts, we require more board independence. I am also concerned that this trend creates the tendency to treat director independence as a substitute for other critical qualities of directors, such as experience, knowledge and diligence.

Turning to shareholders, over the past three decades, a trend in the U.S. that has affected corporate governance is the emergence of institutional investors and greater shareholder activism. Institutional investors, such as mutual, pension and hedge funds, own significantly more publicly traded equity securities today than they did a few decades ago. Some institutional shareholders have become very active in the corporate governance arena. Over the years, they have submitted shareholder proposals to individual companies in which they own stock for inclusion in those companies' proxy statements. These proposals have called for a myriad of reforms, such as the elimination of staggered boards, majority voting, director qualification standards and executive compensation limitations.

While institutional investor activism has, in some instances, encouraged corporate governance reform for the benefit of all shareholders, I do not believe it is the definitive solution to preventing corporate misconduct. Fund managers are trained and tasked with identifying the variety of investment choices available for the fund given its strategy, analyzing those possible investments from a financial and business point of view, and investing the fund's capital to achieve the best return for fund investors. Their paramount concern should be the fiduciary duties they owe to their own investors, not the corporate governance policies of companies in which they may invest. In addition, the fund manager's investment objectives and time horizons may be much different from those of individual shareholders and of other fund managers investing in the same company. Some institutional investors may have political or other agendas, tangentially related or even wholly unrelated to maximizing returns for fund shareholders from a particular investment.

In the context of these trends, a number of regulatory and other actions have recently been and are being proposed and discussed. Starting with

fraud deterrence and prevention after the corporate scandals, Congress and regulators realized that to elicit fuller and more accurate disclosure, the laws and rules needed to change. Effective corporate governance became paramount to restoring investor confidence. The result was multi-faceted: Sarbanes-Oxley; new rules and regulations; increased civil and criminal enforcement activity; and a new market environment. By and large, these efforts have been successful, with some exceptions, such as problems with implementing Sarbanes-Oxley Section 404 on internal controls effectively and efficiently, which we at the SEC and the Public Company Accounting Oversight Board are working to address.

Regarding management compensation, in January, we proposed changes to our rules on executive and director compensation disclosure. While the Commission does not and should not be setting compensation levels, we proposed rules designed to make disclosure regarding executive compensation clearer and more comprehensive. This would better enable the market to evaluate the appropriateness of a firm's compensation of its senior management and directors.

Of particular note, the proposed rules would require that an issuer disclose in one specific place the amount of total compensation it pays to its CEO, CFO and the three other highest paid executive officers and its directors. In certain cases, the proposed rules would also require disclosure regarding three other highly compensated non-executives (note, these last three persons would not be identified). We have reviewed a large number of comments on this proposal, and I know our staff is working to address some very valid concerns that have been raised.

As to stock options, the proposed rules would require that companies provide valuation and other more comprehensive disclosure than is required under the current rules. I think the Commission should consider a practice that has its origins here, on this side of the Atlantic, specifically, the U.K. This would require companies to disclose the full inventory of each named executive's options, including the award date, vesting date, expiration date, and exercise price of each award. The comment period on these rules closed in April, and the Commission will consider issuing final rules very soon.

Regarding the backdating of stock options, which has gotten significant attention lately, some of the changes to our reporting requirements may have already helped to ameliorate this problem going forward. The securities laws and our rules have required for some time that executive officers, directors and large shareholders report, in Commission filings, most purchases and sales of the company's securities. A few years ago, for reasons unrelated to option backdating, we shortened dramatically the filing deadline for these reports to two business days after the option grant date. While our rules occasionally have negative unintended consequences, this rule change actually had a positive unintended consequence - it essentially eliminated the opportunity for companies to backdate awards before they had to disclose them. Also, since, starting this past year, stock options have to be valued and expensed in the financial statements, an independent auditor will be auditing the expensing of the grants. Boards can still award backdated options, but only if the grants are properly approved, disclosed and then expensed. That being said, I believe that securities law violations in connection with backdating should be dealt with swiftly in Commission enforcement actions.

Another corporate governance issue that would impact each of the three constituencies regards shareholder proxy access in director elections. Three

years ago, the Commission proposed rules that would have allowed certain shareholders to place the names of director nominees in the company's proxy solicitation materials and proxy card. We never issued final rules. Arguments against proxy access included that, under current law, shareholders are free to utilize the proxy rules to solicit votes for their own nominees in director elections. Another argument was that proxy access might allow special interest groups to unduly influence the election process. Not all shareholders have the same interests. Arguments in favor of proxy access were that it would diversify boards, and give shareholders a more prominent voice in decision-making.

During the past year, many activist institutional shareholders have been calling upon companies to adopt majority voting for director elections as opposed to what has been more common, plurality voting. Under the plurality model, directors who receive the greatest number of favorable votes are elected. Shareholders cannot vote against director nominees, but can only withhold or not cast their votes. Thus, most nominees are elected, even if they receive very few favorable votes and even if many votes are withheld or not cast. Under majority voting, to be elected, a nominee must get a majority of the votes cast. The states in which most U.S. public companies are incorporated make either of these models available to corporations. Corporations can specify one of these methods in their charters, so shareholders can ultimately determine which of these methods they want the corporation to apply.

My personal view is that majority voting makes sense. What is not clear is the best way to make it happen. I am encouraged that a trend toward majority voting appears to be emerging. Some companies are beginning to adopt majority-voting standards. In other cases, shareholders have approved shareholder proposals for majority voting. In addition, a committee of the American Bar Association is disseminating proposals relating to shareholder voting in director elections. The proposals would recommend revisions to state corporate law which, if adopted, would encourage majority voting.

As I said, my tenure as an SEC Commissioner ends next month. It has beer an honor and a privilege to serve my country in this position. One of the highlights of my term has been to work with my colleagues outside the U.S. in forums such as this. The importance of a global dialogue has never been more critical. We all face similar challenges, within different environments. We can all learn from one another. No model is perfect, and one size definitely does not fit all. As we deal with corporate governance or other challenges, be they accounting convergence or cross-border exchange mergers, we will all be better off if we work together, with the common goal of protecting our investors and strengthening our markets.

Thank you for the opportunity to address this distinguished group.

http://www.sec.gov/news/speech/spch062706.htm