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Mandating Corporate Behavior: *Can One Set of Rules Fit All?*

By George S. Dallas & Hal S. Scott | Spring 2006

Based on a Panel Discussion on the Current State of Corporate Governance in the Global Marketplace sponsored by:

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Preface

On Dec. 6, 2005, Standard & Poor's, *BusinessWeek*, and Harvard Law School's Program on International Financial Systems (PIFS) joined to present a half-day symposium at the McGraw-Hill Companies auditorium in New York, focusing on key issues of corporate governance affecting companies, investors, and financial markets globally. With the ambitious title "Mandating Integrity and Transparency," the discussion focused on the following areas:

- Board independence and effectiveness
- The role and independence of the auditor
- Shareholder rights and shareholder activism
- Convergence of global corporate governance systems

Harvard Law School Professor and PIFS Director Hal Scott moderated the program in a Socratic-style panel discussion featuring a unique collection of international experts on corporate governance. These panelists represented a wide range of professional experience and accomplishment in areas including institutional investment, financial market regulation, corporate boards, corporate management, accounting, law, credit rating, journalism, and academia. In addition to this professional diversity, a key distinguishing feature of the panel was the range of different geographic perspectives, reflecting representation from the U.S., Japan, China, and from several countries in Europe. The panelists were:

Paul S. Atkins, Commissioner, U.S. Securities & Exchange Commission

Dr. Rolf-E. Breuer, Chairman, Deutsche Bank Supervisory Board

John A. Byrne, Executive Editor, *BusinessWeek*

George S. Dallas, Managing Director & Global Practice Leader,
Corporate Governance, Standard & Poor's

Pierre Delsaux, Acting Director for Free Movement of Capital,
Company Law and Corporate Governance, European Commission

Guido Ferrarini, Professor of Business Law, University of Genoa

Richard Kilgust, Global and U.S. Regulatory Affairs Leader, PricewaterhouseCoopers

Jay W. Lorsch, Louis E. Kirstein Professor of Human Relations, Harvard Business School

Elaine La Roche, Independent Non-Executive Director, China Construction Bank and Non-Executive Chairman of the Board, Linktone

Masatsugu Nagato, Managing Executive Officer Americas, Mizuho Corporate Bank

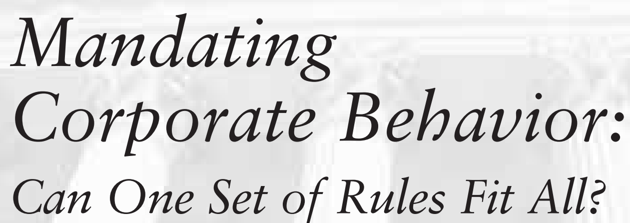
Eric D. Roiter, Senior Vice President & General Counsel, Fidelity Management & Research

Jochen Sanio, President, German Federal Supervisory Authority

Sarah Ball Teslik, CEO, Certified Financial Planner Board of Standards Inc.

The transcript of this event is presented in the Appendix and provides the foundation and basis of reference for this paper. Given the breadth of subjects discussed, as well as the size and diversity of the panel, the discussion did not cover each theme exhaustively. Nor were consensus views formed—or even attempted. However the panelists' comments provide a wealth of informed insights into the complex issues that were discussed. If nothing else, the range of views expressed helps to explain why there are no simple answers to many important questions of global corporate governance.

The commentary that follows draws from the key themes of this symposium, and represents the authors' (Hal Scott and George Dallas) own views and conclusions regarding the governance themes discussed at this conference. These comments do not necessarily reflect the views or positions of the other panelists or the authors' employers, Harvard Law School and Standard & Poor's, respectively.



Mandating Corporate Behavior:

Can One Set of Rules Fit All?

Board Independence And Effectiveness

Corporate boards are at the heart of the corporate governance debate, given their integral responsibility for monitoring and controlling executive management on behalf of the company and its shareholders. The importance of board independence and the role of independent directors is an area of particular focus and concern for widely held companies, given the classic agency problem of how small and diverse shareholders can ensure that managers are acting in the interest of shareholders as opposed to their own self-interest. At least theoretically, independent directors serve as a partial solution to this agency problem by providing checks and balances on executive behavior. However, for closely held companies the role of independent directors is somewhat different, given that controlling shareholders in these situations are often well positioned to provide oversight of executive management—or sometimes are executive managers, as well as shareholders. This gives rise to a different type of agency problem: the extent to which the interests of controlling shareholders might differ from those of small shareholders.

The discussion at the December panel began with the theme of board independence—with a particular focus on the differing roles of independent directors in markets around the world. While director independence is a much-discussed topic, and is the subject of both "hard" and "soft" law and regulation, it is clear there is no consistent or agreed-upon standard of director independence globally, in part because of differing ownership structures and business practices. In the U.S. and U.K., where most large public companies are widely held, regulatory requirements call for a majority of independent board directors, and in practice many listed companies have boards with nominally independent directors often representing two-thirds or more of the board. This focus on independent representation is arguably most pronounced in the U.S. NYSE and NASDAQ listing rules call for a majority of independent directors for all noncontrolled U.S. companies, and it is not uncommon to find U.S. boards with only one executive representative (the CEO or CEO/Chair)—with the remaining directors identified as independent nonexecutive directors. The

U.K. Combined Code also calls for a majority of independent directors, although on a more voluntary "comply or explain" basis, and U.K. boards tend to feature relatively more executive or nonindependent directors than is the norm on U.S. boards.

This Anglo-American approach to board structure contrasts notably with the norm in continental Europe, where independent directors play a more limited role—in part reflecting more concentrated ownership and greater involvement by owner/managers. The U.S. approach differs even more radically from that in Asian countries such as Japan and China, where board independence is much more limited, given different cultural and social traditions, concentrated ownership, and differing stages of economic development. Particularly in emerging markets such as China, the small pool of legitimate independent director candidates provides a practical limitation on the ability of independent directors to play a more meaningful role in corporate governance.

Does independence matter?

Given these differences in approach, the panel discussion touched on the relevance of independence as an issue, both in the U.S. context and for closely held companies that represent the norm in most markets outside those of the U.S. and U.K. It is noteworthy that one panelist called the topic of independence "boring," while others challenged the conventional wisdom regarding the relative importance of board independence as compared with the importance of other board attributes. The panelists generally acknowledged the aspirational merits of director independence. However, they had reservations related to practical concerns.

These reservations include:

Lack of empirical evidence. Some research studies highlight investor interest in board independence and suggest potential relationships between board structure and company performance, but most of the empirical evidence on the question of board independence (at least in developed markets) is inconclusive in terms of causal links between board independence and company performance. To some extent this speaks to definitional problems (see below) and to the difficulties that researchers face in conducting studies that meaningfully capture independence as an attribute. However, for

studies employing rule-based definitions to define director independence, the evidence thus far does not provide compelling arguments to link independence and company performance. While future research may yield more conclusive insights about the impact of board independence, the current emphasis on it is arguably more theoretical than fact-based.

Definitional problems. One theme on which the panelists appeared to approach consensus is that a rule-based approach to defining director independence is problematic. On more than one occasion, panelists described independence as a "state of mind"—one that defies a mechanistic definition of what it is and is not. While creating brightline rules for independence might serve as a filtering mechanism, these are only crude proxies. In other words, there may be directors with true independence of mind who may not qualify as independent on the basis of rule-based criteria. On the other hand, and possibly more commonplace, there will be directors who meet established criteria for independence, but do not act independently in practice. Given these definitional challenges, the notion that board independence can be mandated by guidelines prescribing minimum proportions of nominally independent directors is potentially flawed.

Trade-offs: independence versus company/industry knowledge. Even for directors who meet standards of independence in both thought and action, practical difficulties temper the notion that independent directors provide a complete solution to the agency problem of a self-interested management. In part this reflects the limited time that independent directors are able to devote to management oversight and control and to developing an in-depth understanding of the company and its sectors of activity. It may also reflect the lack of financial incentive that comes with not having a lot of personal economic exposure to the company. More fundamentally, when independent directors lack specific company or industry knowledge, they are less able to ask pointed questions about business or operational risks—to have a sense of where "the bodies are buried." Indeed, to the extent that independent directors are dependent on executive management to help them understand these risks, this creates its own form of nonindependence. Ironically, directors who nominally are not independent but have thorough company or industry knowledge may be better positioned to exercise more substantive independent oversight than nominally independent directors.

On more than one occasion, panelists in the December seminar mentioned the importance of industry experience on the board—in some cases suggesting that this can be an appropriate trade-off for independent representation.

One size does not fit all: ownership matters. The panel made clear that independence norms for widely held companies are different than those for closely held companies. The case for director independence is arguably greatest where there is diverse ownership, given the lack of a controlling shareholder to monitor management at close range. This explains the norm of majority independence in the U.S. and the U.K. For widely held public companies, this remains a sensible rule of thumb, but not necessarily an inviolable proposition in cases where companies may have good reason to opt for less-independent structures.

At the same time, there remains a role for independent directors even in closely held companies—particularly with regard to addressing the potential conflicts of interest relating to controlling shareholders. In controlled public companies, or even in companies where investors hold significant blocks of less than 50%, there is the need for some critical mass of independent directors to exercise influence on the company's board and governance culture. A brightline rule requiring a specific percentage of independent directors is problematic for closely held companies. But minority investors need to be aware that if independent directors comprise less than a quarter or a third of the board, it might be difficult for them to play a meaningful role in practical areas such as committee composition. There is no generic answer, however, and each company must be assessed on a case-by-case basis, given its ownership, stage of development, and other firm-specific factors. Differing ownership structures as well as different stages of a company's life cycle might call for differing degrees of independent oversight. In other words, the need of a mature, large cap public company for independent influence on the board is not necessarily the same as that of a newly listed small cap firm. While there is a role for independent directors in all corporate structures, the needs are dynamic and will likely evolve over time.

Challenging conventional wisdom?

These considerations may challenge many conventional assumptions about the practical importance of independent directors. While the aspirational merits of board independence are important to affirm, it is also the case that

the practical effectiveness of independent directors can be limited and should not be overrated. Indeed, independence is only one of several factors affecting overall board effectiveness, with other attributes including the right skill mix, which includes relevant industry and geographical knowledge. This reflects a "portfolio of talent" approach to board composition that can accommodate both independent and nonindependent board directors.

If nothing else, this suggests that a formulaic approach to independent director representation is problematic, and that caution might be warranted not only in cases where independent representation is too low, but also in cases where it may be too high. However, in challenging the importance of independence relative to other board attributes, care must be taken to avoid a wholesale dismissal of the role of independent board oversight. The key is to find the right balance for individual companies given ownership, industry, and life cycle considerations. There will not be a uniform or generic solution that is optimal for all firms. This is something that investors, stakeholders, and standard-setters should recognize.

Given these uncertainties, the requirement for majority board independence in the NYSE listing rules may be unduly rigid in individual situations, and stands in contrast to the more voluntary comply or explain approach adopted in the U.K. To the extent that regulatory policy is to intervene in a granular way that affects board composition, it is arguably more important to focus on areas of governance where independence adds the most value. This might suggest the logic for more specific regulatory guidelines in such areas such as independent representation on functional committees (audit, nomination, and remuneration) or for independent review of related-party transactions—rather than the imposition of rules for the structure of the board as a whole.

It is unlikely that waiving or loosening the current NYSE requirement for majority independent representation would result in a wholesale shift in the structure of U.S. corporate boards toward insider domination. Investors and other market participants would continue to press for independent directors to provide oversight of management and to protect against conflicts of interest. But a more discretionary approach would provide flexibility for companies to adopt different structures if they are able to provide a compelling explanation of the business case.

Awareness of the potential limitations of regulation to foster board independence can in turn focus attention on practical and voluntary mechanisms at the individual firm level on how to address or possibly overcome these limitations. Increasingly, boards are developing new structures and processes to enhance the effectiveness of independent directors, such as lead independent directors, executive sessions, peer reviews, director training, and greater exposure to external assessments/advice from independent third parties. Such measures must be tested over time to properly assess their impact. If undertaken in a narrow spirit of regulatory compliance, these mechanisms may amount to no more than superficial box ticking exercises. But if adopted voluntarily in the spirit of best practice, there is greater likelihood that structures and processes of this nature can contribute meaningfully to an independent board culture, and ultimately to better performance.

Corporate boards are ultimately political structures within commercial organizations. Therefore, political correctness for its own sake may mean very little if it inhibits or does not support commercial development or value creation. If a company can explain truthfully and clearly how investor interests are otherwise adequately protected, then an overly rigid requirement for independent directors should not rank ahead of the company's need to structure boards to ensure optimal performance for shareholders and other financial stakeholders.

Role Of The Outside Auditor

The outside auditor plays a crucial role in ensuring the integrity of a company's financial statements and underlying reporting system. The accuracy of financial accounts is key to the management of the company and to investor decision-making. The integrity of the audit process is a matter of concern in all jurisdictions globally. However, regulatory and managerial approaches differ in terms of how to best provide third-party independent oversight of financial statements and internal controls.

The U.S.: most prescriptive approach

In the U.S., public companies are required to have an audit performed by an independent auditor, and independence is very strictly defined. Under the Sarbanes-Oxley Act of 2002 (SOX), the outside auditor must be hired by, and report directly to, an entirely independent audit committee. The Act also prohibits a firm's auditor from providing consulting services to an audit client, requires audit partner rotation, and sets stringent requirements for an external audit of internal controls (Section 404) that must be certified by the auditor, as well as by the CEO and CFO (Section 302).

Under U.S. exchange listing requirements, the audit committee must contain at least one financial expert, and all of its members must be financially knowledgeable. These requirements are mandatory for foreign registrants, unlike the requirements for a majority of independent directors. The Public Accounting Oversight Board (PCAOB) oversees and sets standards for all auditors of U.S. publicly traded firms, including the auditors of foreign registrants.

Other countries do require outside auditors, but their rules governing the nomination and monitoring of auditors, plus their independence and reporting lines, are far less demanding than those of the U.S. In Germany, for example, the outside auditor is accountable to the Supervisory Board, which is composed of outside, but not necessarily independent, directors. In European countries with single board systems, there is generally no requirement that audit committees be composed entirely of independent directors. The EU recommends that there be a majority of independent directors on the audit committee but this recommendation is nonbinding. In Japan, the outside

auditor reports to either the statutory board of auditors, in the traditional two-tier board system, or to the audit committee in the new one-tier system. As of 2006, both the statutory board and the audit committee must be composed of a majority of independent directors, though the traditional statutory board carries less power than does a formal board audit committee.

None of the countries represented on the panel has a regulatory agency equivalent to the PCAOB, nor internal control requirements like those of Sarbanes-Oxley Section 404. Nor do countries mandate the separation of auditing and consulting, although the EU's 8th Company Law Directive, which will become effective in 2008, recommends separation. Many companies in Europe and Japan have voluntarily decided to separate the provider of the two services.

The U.S. liability standards are much higher than those in other countries, and these U.S. standards are enforced in large part by class action lawsuits not permitted elsewhere. These lawsuits can generate huge damage awards, as in the Enron and WorldCom litigation. The prospect of potential liability can drive firms and their auditors in the U.S. to take their responsibilities more seriously. Although liability existed even before the accounting debacles of the early 2000s, this matter is now of greater concern as a result of the Arthur Andersen example at Enron and other large settlements recently made by the Big Four accounting firms. Some would say that accounting firms are taking their liability concerns too seriously, as shown by corporate sentiment that Section 404 has led to overly stringent audits.

Is auditor independence a problem?

The requirement of auditor independence is crucial to the auditor's role of ensuring the quality of a company's financial reporting. While many question the need for independent directors, few would question the need for independent auditors. On the other hand, assuring independence can be difficult. As one of the panelists noted, auditor conclusions can be a degree or two too "sunny." Auditors depend on the fees they receive from companies, which means there might be a temptation to avoid delivering bad news at the risk of losing an engagement. This is unrelated to whether other consulting services are provided, although in such a case, the risk potentially is magnified.

This potential conflict of interest can be mitigated (though not eliminated) by a diverse client base, partner rotation, more robust oversight (e.g., the PCAOB in the U.S.), independent audit committees, and auditor selection processes. There is not much evidence, however, that the separation of auditing and consulting increases independence, because auditors still depend on their audit fees. Additional important factors come in to play in the high liability environment of the U.S., where audit firms may fear another failure on the scale of Arthur Andersen, and outside directors might fear being personally forced to fund damage awards above their insurance limits, as in the instances of Enron and WorldCom. Other factors also contribute to ensuring independence, such as fiduciary responsibility, professional ethics, peer interaction, and the fear of loss of reputation.

A major concern of corporate issuers with the audit rules in the U.S. is Section 404, which some estimate imposed a $5 billion cost on U.S. firms in its first year of existence. The ability of firms to use audit services to control these costs is significantly affected by the degree of auditor concentration. The Big Four audit 97% of all companies with sales of more than $250 million a year. Because of specific relationships for many firms, such as consulting or audit firms working with key competitors, the effective choice may be less than four audit firms. Not all of the four audit firms provide services for specialized industries; nor are all equally prominent in different geographical regions. In addition, companies may have other relationships with audit firms that prevent these firms from being independent. Just as importantly, firms are wary of switching auditors lest that create a negative impression in the marketplace.

Auditor concentration is a reality and is not likely to go away unless there were some form of forced breakup (e.g., AT&T's divestiture of its local exchange service operating companies into the seven independent "Baby Bells")—which no one currently advocates and which would probably deprive the users of auditing services of the economies of scale and breadth of expertise achievable in a large firm. There is little reason to expect new entry or significant growth in the size of second-tier firms to the point they will become comparable in size to any of the Big Four firms. Panelists noted that multinational companies require auditors with multinational capabilities, and this fundamental requirement for

technical skills and geographic diversity will create natural limits on the number of audit firms.

Ironically, while the concentration of audit firms raises real concerns about the level of fees, this concentration may be a major factor in assuring auditor independence—if a customer cannot switch auditors, the auditor's power, and therefore, its ability to act as it sees fit, is greatly enhanced. So a key aspect of this concentration problem is striking the right balance between independence, prudent financial services, and reasonable fees.

Auditor regulation and liability: international concerns

In considering ways to deal with the challenges created by concentration, it is important to realize that companies and countries all over the world will be affected by what happens in the U.S. When the U.S. Department of Justice effectively put Arthur Andersen out of business by bringing a criminal prosecution, auditing choices were narrowed not just for U.S. companies, but for all companies. Therefore, some kind of international approach to the auditor concentration issue should be considered.

One way to deal with high audit fees would be to regulate them. But that approach, like break up, may be worse than doing nothing. The U.S. government's experience with setting fees is not a good one. The PCAOB has tried the jawbone approach, calling on firms to take a more "top down" and "risk-based" approach to Section 404 audits, thus reducing costs. But these exhortations have largely fallen on deaf ears at auditing firms that face potentially huge liability if they overlook a problem.

A second possibility would be to place some kind of cap on auditor liability. The EU has initiated a study to explore this approach. A cap, however, should not consist of limiting liability to the level of insurance coverage, because this would only drive down insurance coverage and eliminate incentives for auditors to exercise due care in their audits.

Another approach to caps would be to permit auditors to limit liability by obtaining indemnification from clients. The SEC believes any kind of indemnification is inconsistent with keeping auditors independent.

Moreover, the U.S. Federal Financial Institutions Examination Council (FFIEC) has advised financial institutions that such indemnity would be an unsafe and unsound practice. Nonetheless, the PCAOB is evaluating the possibility of the use of indemnities. One possibility would be to permit auditors to seek indemnification in all cases other than where auditors were judged as reckless. Alternatively, one could readjust the liability standard itself, from negligence to recklessness, but this might be more difficult to do given the need for SEC, and perhaps even congressional, action.

Still another possibility would be for the PCAOB and the SEC to define a safe harbor for acceptable auditing practices, as suggested in January 2006 by the U.S. Chamber of Commerce in its report, "Auditing: A Profession at Risk." The PCAOB has previously stated that it cannot define "overauditing," and that any effort of this kind would lead to a massive rule-book approach to auditing, just the opposite of the "principles-based" approach that we should be adopting for accounting rules generally. Again, it must be reemphasized that this is an international problem and that the U.S. regulators and standard-setters should actively collaborate and consult with those in other countries to reach a solution.

A final observation on this subject is relevant to developing countries. As one panelist indicated, many countries (including China) do not have the auditing resources to meet requirements such as Section 404—they are stretched to do adequate financial statement audits, let alone more. The effect of requiring all public companies, foreign as well as domestic, to meet these standards effectively precludes companies from these countries from listing on U.S. exchanges. More generally, the U.S. should be concerned that the high costs of auditing requirements may lead companies—even those that could comply—to list abroad, and may lead non-U.S. companies to exit or not come to U.S. public capital markets.

Role Of The Shareholder: Activism And Shareholder Rights

The panel discussion also considered the question of the appropriate level of shareholder activism and rights as compared with the powers of management and outside directors. To a large extent, the approach to this question reflected the extent to which shares of companies in a particular country are widely or narrowly held. Various legal, historical, and cultural factors have led to differing ownership patterns in different parts of the world. Studies have shown that single shareholders exercise control of most companies in continental Europe and Asia, whereas ownership of public companies is more widely dispersed in the U.S. and the U.K.

U.S.: limited shareholder rights and investor conflicts

Generally, shareholders have fewer rights in U.S. companies than do shareholders in non-U.S. companies. Specific U.S. shortcomings include the lack of rights to call special meetings, to nominate directors through access to the ballot distributed by the corporation, and to approve the adoption of antitakeover measures. In widely held companies, small shareholders are unlikely to exercise their rights—the cost of doing so (intelligently) exceeds the benefit. This is obviously the case for the average retail investor as well as for wealthy individuals and mutual funds holding diversified portfolios. It is easier to sell one's position in a company than incur the costs of trying to change its policies.

Particularly in the U.S., institutional investors, such as mutual funds, might also be unwilling to challenge management as they are potential candidates to manage a company's pension or other retirement funds. In addition, there has been a fear in corporate America that shareholders who would exercise an expanded set of rights would do so to pursue political or social—rather than economic—objectives that were not in the interests of shareholders as a whole.

Continental Europe: more rights, but effective only for majority shareholders

In Europe, nominal shareholder rights are typically more prevalent, but given that the vast majority of companies have concentrated ownership,

these rights are only effectively exercised by the majority. This is particularly so in companies in which insiders hold shares with multiple voting rights—a common practice in France, the Netherlands, and Sweden. In Europe and Asia, dominant shareholders have naturally demanded strong rights commensurate with their ownership positions. These shareholders do not look to independent directors to protect their interests—they control the boards and maintain close scrutiny of managers.

The problem in Europe and Asia lies with the potential that the dominant shareholders engage in self-dealing to the detriment of the minority shareholders. This would, in turn, lead to less public investment and more difficult exits for majority shareholders. Nonetheless, the hands-on approach of dominant shareholders in some cases might result in more efficient management and better returns than are achievable in the widely held corporation. Dominant shareholders can be positive, negative, or neutral influences on the interests of small investors. This must be assessed on a case-by-case basis. It can be argued that the U.K. has the best balance here, offering more complete shareholder rights than the U.S. and a less-concentrated system of ownership and control than continental Europe.

Shifting ownership patterns and influences

An important question is whether or not the prevalence of the widely held corporation, which underpins the U.S. approach to corporate governance, is significantly changing. Traditional institutional ownership of U.S. equities remains significant—around 50% of overall market capitalization of the NYSE. However, there does appear to be an increase in the percentage ownership of public companies by private equity, either in partnership with corporates or as they exit over time from the private market by going public. These large shareholders do have a governance interest that diversified funds do not have and have much more of an interest in actively exercising shareholder rights. Private equity returns consistently outperformed the S&P 500 Index from 1980 to 1997. This development may argue for facilitating the influence of private equity investors over the companies in which they have major stakes, by increasing their rights to nominate their own directors and to otherwise have significant input into major corporate decisions.

Non-U.S. companies are also undergoing changes in ownership structure. They are becoming more widely held as traditional control owners such as banks, families, and the state sell off their shares. In Japan, for example, there has been a sea change produced by the dismantling of the cross-shareholding *keiretsu* system. This might also result in a less stakeholder-oriented attitude toward the role of the corporation. At the same time new foreign institutional investors, such as mutual funds and private equity, have come on the scene. For example, 20% to 25% of the market cap of the Tokyo stock exchange is now held by international investors. This will bring in new blood. On the whole, it is likely that European and Japanese companies will be more widely held in the future, thus raising the question of whether their corporate governance model, based on active-dominant shareholders, will remain viable. The Anglo-American model, which depends more on directors than on shareholders to control management, may be more appropriate in a more widely held company. Other countries must also strengthen the rights of minority shareholders to maximize the potential for public investment.

Hedge funds: short-term demons?

A different issue may be raised by hedge funds. Hedge funds typically have smaller percentage stakes in a company than private equity holders, and a shorter-term time perspective. Many argue that their interests do not align with those of other shareholders. Thus, even if it might be a good idea to increase shareholder rights for private equity and other institutional investors, hedge funds will also be the beneficiary of these rights and might exercise their rights in a way that is not in the interest of other shareholders.

While hedge funds often hold small stakes, one could argue that small is relative; 1% of a big public company is a major stake compared to the stake of most other shareholders. In addition, hedge funds with small percentages will only have a significant influence on companies when they can potentially outvote (alone or in alliance with others) shares controlled by management. So, if allied with other investors, their influence carries greatest significance. This suggests that “rogue” hedge funds operating in isolation will only have limited influence.

The concept of short-term horizons also needs clarification. While this is a problem that might confront the U.S. market generally, it is inappropriate to demonize hedge funds as exploiting the market's short-term orientation. Arguably, short-term measures only increase share values when the market expects the measures to increase share value over time; a rational market doesn't price equity on returns today, but on expected returns over time. If management seeks to pursue strategies today, such as increased research and development, that do not immediately increase share value, then the market is saying these measures will not work over time. If the market thinks they will work, share value should increase immediately even if net income does not.

In addition, given the average 100% turnover in ownership of U.S. stocks annually, hedge funds are not the only investor group with short-term trading horizons. Indeed, if one measures "short-termism" by the length of time the investor holds the stock, it can be argued that some hedge funds have a longer term interest in the future of companies than do many individual investors.

As for the fear that hedge funds will abuse the rights of other shareholders, given the rights of minority shareholders in the U.S., and the enforcement of these rights by an active SEC and class action lawyers—to say nothing of New York state Attorney General Elliot Spitzer—this concern may be exaggerated. However, the rise of hedge funds in Europe and Asia should give added impetus to the need to increase the protection of minority shareholders.

Cross-border implications

This analysis suggests that the U.S. and Europe/Asia might benefit from swapping their rules to some extent. The U.S. needs to increase the rights of shareholders and place less reliance on the role of independent directors, at least for companies with dominant shareholders. If the U.S. does not make these changes, U.S. companies with dominant shareholders might increasingly go private and stay that way. Exit strategies for dominant shareholders might be to sell to other dominant shareholders, either in private-private mergers and acquisitions, or in the increasingly liquid secondary institutional market, rather than go public. U.S. firms will also explore the possibility of seeking public investors in more shareholder-friendly foreign markets (although the SEC, through Regulation S, greatly limits the ability of

U.S. firms to make offerings abroad in which U.S. investors can participate). Non-U.S. firms with dominant shareholders will stay abroad or leave the U.S. public market (although U.S. obstacles to deregistration currently, and even under a recent SEC proposal make this difficult). In the long-term, however, the U.S. may not be able to protect the attractiveness of its markets by establishing barriers to U.S. investors buying stock issued abroad or by blocking exit from its public market.

At the same time, Europe and Asia need to strengthen the role of independent directors and the protection of minority shareholders. If Europe and Asia do not make changes appropriate for their own circumstances, they will not be able to take full advantage of using the public markets to establish widely held companies, which will impede their capital formation.

In a cross-border voting context, there are also challenges, particularly with regard to legal obstacles to active voting. Some countries block the sale of shares between the time votes are cast and counted, a time period that may be significant enough to impair the liquidity of a company. The EU is now taking measures to eliminate these restrictions.

Toward Global Convergence?

The panel discussion of the governance themes relating to board independence, the audit process, and shareholder rights brought to light the diversity of practices and perspectives on these issues globally. But this discussion did not point to the ultimate resolution or convergence of these differences to form an overarching system of corporate governance that has relevance for all companies in all countries.

To the extent that this pluralistic approach continues to prevail, it will be difficult, if not impossible, to expect a prescriptive set of governance rules and structures to be relevant for global application. This suggests that a granular set of globally relevant governance rules will ultimately fail—or default to a higher order and more general framework for convergence: namely overarching principles, such as fairness, transparency, accountability, and responsibility, which are highlighted by OECD Corporate Governance Guidelines. However, while it might be encouraging and important to build multijurisdictional affirmation of key principles, this does not obviate the arguably more challenging need to develop governance mechanisms to put these principles into practice. In our earlier discussion of board independence, for example, we made note of the pitfalls that can occur when attempting to translate the abstract concept of independence into practical application. So while we may all agree on good principles, we still may disagree on the best way to make them work in practice.

Role and influence of the Anglo-American capital markets and governance standards

Given the size and depth of the U.S. capital markets, combined with U.S. regulation, there is inevitably a strong American accent in existing capital market practices and in resulting corporate governance norms. The U.K. also stands out as a strong global influence in this regard, given its standing as a primary alternative to the U.S. market for international issuance of capital. While packaging these two systems together as an Anglo-American system is overly simplistic and glosses over many fundamental differences between these jurisdictions, the common features of an Anglo-American model currently exert strong influences in terms of governance standards for international capital market participants. These influences reflect in part

the market norms of diverse ownership structures, and emphasize governance attributes such as board independence, independent audit committees, high standards of transparency and disclosure, and a strong orientation to shareholders as compared to other nonfinancial stakeholders.

Longer term, corporate governance standards for international issuers of capital may come under greater influence from standards prevailing in other leading financial market centers. Depending on market developments, this suggests the potential for greater influence from continental Europe, Japan, and even China—with their differing approaches to ownership, board structure, independence, disclosure, and the role of the company relative to its stakeholders and society. However, for the foreseeable future, Anglo-American norms are likely to exert the greatest influence on international issuers of capital. Given this hypothesis, the more interesting near-term question may be whether it is the U.S. or U.K. flavor of Anglo-American governance that will have the greatest influence internationally.

The U.S.: Does the world's biggest market have the world's best governance standards?

While the size of the U.S. market and the extraterritorial reach of regulation such as Sarbanes-Oxley suggest that the American influence will continue to carry strong weight, it is fair to say that the U.S. approach to corporate governance has not won the hearts and minds of market participants outside the U.S. This was reflected in one panelist's reference to U.S. style practices as tantamount to "barbarians at the gate."

Before the Enron scandal, the U.S. market was generally held in high esteem as a global frame of reference, given its breadth, stringent disclosure requirements, rigorous accounting standards, sophisticated capital market practices, and the backdrop of legal enforcement through the SEC and private class actions. However, the Enron, WorldCom, and other scandals demonstrated the vulnerabilities of the U.S. model, which then lost much of its international luster. Attention has shifted from the positive characteristics of the U.S. market environment to many of its weaknesses. These include high regulatory costs, the focus on rules over principles in accounting, concerns about short termism, comparatively limited share-

holder rights, and still-unchecked executive pay (CEO/average worker pay averages 430 to 1 in the U.S. versus 15-25 to 1 in most European jurisdictions). In addition, the strong U.S. orientation toward shareholder capitalism does not always mesh well with a relatively greater focus on nonfinancial stakeholders that exists in many countries. In sum, the U.S. is not now the role model that it once might have been.

These factors suggest that the U.S. governance model may not be embraced as the most appropriate framework to guide global governance convergence—even for those companies seeking access to the U.S. and other international capital markets. A European panelist noted that the U.S. approach to governance reform was being viewed in Europe as a test case, and that preliminary indications are that the pendulum had swung too far in terms of prescriptive regulation. This speaks to a potential problem of "first mover disadvantage" in the U.S.—a problem that other regulatory systems may wish to avoid—or exploit as "fast followers" offering alternative approaches.

Comply or explain: the U.K./European alternative

The U.K. model is well positioned as offering a viable Anglo-American style alternative, which incorporates most of the strengths of the U.S. system, while at the same time avoiding some of its prescriptive extremes. A key feature of this model is its greater emphasis on principles relative to rules and the more voluntary approach of comply or explain as opposed to a more rule-based system. This comply or explain framework has also become the foundation for governance regulation in continental Europe generally, which introduces the wider influence of the EU as a rival to U.S. governance regulation. The influence of continental Europe on global governance practices may be particularly relevant for firms with concentrated ownership structures; for example, in such situations it is unlikely that majority independent director requirements will ever become the norm. In the end, a cocktail of differing governance practices may well emerge as a global standard for companies active in international financial markets. Ideally, these will combine best global practices, which might combine U.S. disclosure standards together with stronger shareholder rights that exist in the bylaws of many European and Asian companies.

In Europe the drivers of governance regulatory policy have shifted from rebuilding investor confidence to focusing on regulation that fosters economic growth and productivity. The flexibility offered by the comply or explain approach is consistent with this shift in emphasis, and forms the foundation of a regulatory competition between the U.S. and European capital markets that will be measured in terms of IPOs, new listings, and delistings.

Softer regulation requires more diligent market scrutiny

If the European comply or explain approach does prove to be a more practical model for global companies than the U.S. approach, we need to be fully alert to its vulnerabilities. The most fundamental of those is a lack of regulatory teeth and lesser ability to provide regulatory enforcement in cases of noncompliance or weak explanations. Therefore, the success of this system will hinge on greater market discipline by market participants themselves as a bottom up force to offset the lesser degree of top down regulatory intervention.

In this regard, to the extent that companies wish to take advantage of voluntary governance standards by opting out of recommended codes of practice, the market (investors, intermediaries, and other gatekeepers) increasingly must seek credible explanations and be prepared to alter investment strategies if these explanations come up lacking. If this does not work in practice, the comply or explain system will be too soft, setting the stage for a pendulum shift back in the direction of tighter regulation. Particularly given the importance placed on a company's explanation in cases of noncompliance, the quality of such explanations should become paramount as an important aspect of narrative reporting.

Conclusion: Investor Governance And Engagement Is Critical

Meaningful investor engagement and proactivity is critical to offsetting the risks of a less-strident regulatory framework. But here is where important gaps may still exist. In a recent study of U.S. institutional investors by Mercer Investment Consulting published this year, corporate governance and corporate responsibility factors were recognized as material to investment performance by 75% of investors surveyed. Yet fewer than half of these investors claim to factor in these factors into their own investment assessments. This disconnect between thought and action speaks to issues of investor governance that may need to be addressed by fund managers and pension funds if a comply or explain system is to be an effective regulatory alternative to the U.S. model.

So to return to the title of our December seminar, we conclude that while it may be possible to mandate specific governance structures and practices, it may not always be advisable. Additionally, and critically, is not possible to mandate the integrity that these practices are meant to realize. Adherence to formulaic governance architecture may mean nothing if it is ill-suited to the realities of individual companies and does not influence the people that inhabit this architecture. There is no easy answer here. For financial markets, this suggests a heightened need for market participants to systematically evaluate governance as a risk factor in individual companies on an ongoing basis and for qualitative judgment of “soft” governance factors to be regularly assessed as a critical component of investment analysis. Investors and research analysts will have a crucial role in ensuring appropriate market scrutiny, particularly in jurisdictions offering more flexible regulatory approaches to corporate governance.

Authors' Biographies

George S. Dallas

George S. Dallas is Managing Director and Global Practice Leader for corporate governance at Standard & Poor's. Based in London, Mr. Dallas has led Standard & Poor's global corporate governance initiative since the late 1990s, and has led the development of an analytical approach to corporate governance and with developing corporate governance evaluations on individual companies in mature and emerging markets around the world. He is actively engaged with Standard & Poor's wider enhanced analytics initiative—linking corporate governance evaluations more formally to the credit rating process.

Prior to this assignment Mr. Dallas was head of Global Emerging Markets for Standard & Poor's. He also has served as regional head for Standard & Poor's Ratings Services in Europe and has been head of Standard & Poor's London office and practice leader of the company's international corporate ratings group. He joined Standard & Poor's as an analyst in 1983, prior to which he was a corporate lending officer at Wells Fargo Bank.

Mr. Dallas is editor of the book *Governance and Risk* (McGraw Hill, 2004), and has written many articles and several book chapters on themes relating to corporate governance and international finance. He is a member of the European Corporate Governance Institute and the International Corporate Governance Network. Mr. Dallas is also a member of the advisory board of the Duke University Global Capital Markets Center and has served on the boards of Standard & Poor's affiliates in France and Spain. He has been a member of the Global Reporting Initiative's Investor Consultation Group (2005) and was also a member of the United Nations Environment Program's expert group on Responsible Investing (2005). He is currently a member of a U.K. Department of Trade and Industry steering group overseeing academic research to guide U.K. regulatory policy in the area of corporate governance. In 2003, Mr. Dallas won the McGraw-Hill award for Excellence in Leadership.

Mr. Dallas holds a B.A., With Distinction, from Stanford University and an M.B.A. from the Haas School of the University of California at Berkeley. Mr. Dallas has dual nationality in the U.S. and the U.K. He speaks German and French, and has a working knowledge of Russian.

Hal S. Scott

Hal S. Scott is the Nomura Professor and Director of the Program on International Financial Systems at Harvard Law School, where he has taught since 1975. He teaches courses on Banking Regulation, Securities Regulation, International Finance and the Payment System.

He has a B.A. from Princeton University (Woodrow Wilson School, 1965), an M.A. from Stanford University in Political Science (1967), and a J.D. from the University of Chicago Law School (1972). He is been admitted to practice in Massachusetts and various federal courts. In 1974-1975, before joining Harvard, he clerked for Justice Byron White.

The Program on International Financial Systems engages in a variety of research. Its latest project is a book on *Capital Adequacy Beyond Basel* (Oxford University Press 2004), an examination of capital adequacy rules for banks, insurance companies and securities firms. The program also organizes the annual invitation-only U.S.- Japan and U.S.- Europe, and U.S.- China Symposia on Building the Financial System of the 21st Century, attended by financial system leaders in the three countries. The program directs Socratic-style dialogues among financial leaders on issues of current interest, e.g. The Current State of Corporate Governance in the Global Marketplace with *BusinessWeek* and Standard & Poor's in 2005. The program also directs a concentration in International Finance for LLM students at Harvard Law School.

Professor Scott's books include the law school textbook *International Finance: Transactions, Policy and Regulation* (12th ed. Foundation Press 2005) and *International Finance: Policy and Regulation* (Sweet & Maxwell 2004). His recent articles include "A Bankruptcy Procedure for Sovereign Debtors?", *37 The International Lawyer 103* (2003) and "Internationalization of Primary Public Securities Markets Revisited" in *Capital Markets in the Age of the Euro: Cross-Border Transactions, Listed Companies and Regulation, eds. K Hopt, E. Wymeersch and G. Ferrarini* (Kluwer 2002).

Professor Scott is a member of the Shadow Financial Regulatory Committee and an independent director of Lazard Ltd. He is past President of the International Academy of Consumer and Commercial Law and past Governor of the American Stock Exchange (2002-2005). He has served as a consultant to a variety of financial institutions, multilaterals and governments.

Appendix:

Proceedings Of "Mandating Integrity And Transparency" Symposium | *Dec. 6, 2005*

Hal Scott: I want to thank our sponsors, Standard & Poor's and *BusinessWeek*, for helping us put on this event.

I want to introduce Kathleen Corbet, who has been president of S&P since April 2004. Before joining S&P, she served as CEO of the Fixed Income Division of Alliance Capital Management, and as a member of Alliance's Executive Committee. I also want to introduce Joyce Barnathan, the Executive Editor of *BusinessWeek*. Before becoming Executive Editor, she was an Assistant Managing Editor, responsible for the magazine's finance, economics, and personal business departments. Kathleen?

Kathleen Corbet: Thank you, Hal. Good morning, everyone. That so many of you are here with us today underscores the fact that corporate governance continues to be a crucial agenda item for all of those who participate in global markets.

Our goal today is quite simple: to bring together a variety of perspectives in a dialogue on this very important topic. To do this, we have a panel of very distinguished international experts whose insights will deepen our understanding of the current and global state of corporate governance, and reflect on the issues and challenges that lie ahead. I do want to thank each of our panelists for taking the time to be with us and to share their views. I also want to thank our cohosts, the Harvard Law School Program on International Financial Systems, with which Standard & Poor's has certainly had the pleasure of partnering on this conference for the last three years, and *BusinessWeek*, our sister organization, and the McGraw-Hill Companies, who join us as a cosponsor this year.

Now, I think you'll agree that there's not an area that's more closely watched by both investors and creditors than governance, and this is true in every developed and emerging market around the world. Indeed, legislation and codes of best practices that have been introduced in Europe, in North America, and in Asia have raised the bar on governance policies and practices. And while all of this is laudable, it is clear that the risks of bad governance have not and cannot be entirely eliminated by regulation.

So the upshot is this: Investors must do more than simply stay engaged with corporate governance. They must be catalysts for further progress in this

area. For many years, Standard & Poor's has been actively focused on addressing and assessing governance risk for investors in our core analytic services, both in credit ratings and in equity research. For a closer look at S&P's approach in this area, you may want to take a look at the special edition of *CreditWeek* that's in your program kits. It focuses exclusively on corporate governance, with articles by S&P's analysts in the U.S., in Europe, and in Asia, as well as our conference moderator, Professor Hal Scott, the Nomura Professor of International Financial Systems at Harvard Law School. *(Editor's note: A pdf file of these articles is available by contacting research_request@standardandpoors.com.)*

In their examination of the evolution of governance, our analysts and our authors point out that as more companies come to terms with regulatory requirements, the governance debate is shifting. It's shifting beyond basic regulatory compliance and evolving toward a focus on broader enterprise risk and strategic oversight issues. It's these companies that have grasped the importance of building and nurturing trust with investors and all key stakeholders. They understand that this requires a cultural transition from simple legal compliance to enterprisewise fairness, integrity, accountability, transparency, and enhanced reporting of financial performance. I think that many of us here today believe that this is a trend that will continue to gain traction, and at the very least, it is clearly a focal point to be recognized and monitored in this rapidly changing environment, and perhaps to be examined more closely in our discussions today.

So I want to thank you for joining us. I look forward to a constructive and valuable session. And now I'd like to call on my colleague, Executive Editor of *BusinessWeek*, Joyce Barnathan. Thank you.

Joyce Barnathan: On behalf of the editors of *BusinessWeek*, I can say that we're very delighted to be part of this program.

Nine years ago, my colleague John Byrne, who is sitting on the panel today, developed *BusinessWeek*'s own report card on corporate governance called "The Best and Worst Boards." In that issue, we actually argued that there was a correlation between a company's performance and its governance. We posited that the best performers "risked stumbling someday if they lack

strong and independent boards of directors." For decades, U.S. executives and powerful fund managers have lectured Europeans and Japanese about the need to run their corporations according to the more transparent U.S. model. Then came the corporate scandals of 2002, and that was followed by Sarbanes-Oxley, arguably the single most important piece of legislation since the U.S. securities laws of the 1930s. Despite all the grousing about Sarbanes-Oxley, many experts believe that U.S. companies overall are far better for it.

The U.S. isn't the only country where shareholders are demanding better governance. The momentum is strongest in Europe, where investors are challenging companies as never before. And there's more sensitivity to governance issues in Asia as well. I worked in Asia for seven years, and you can see that starting to happen, although the region's family- and government-controlled companies still face plenty of conflicts of interests. And you can even see progress in Japan, where the overhaul of the financial sector is driving the nation's recovery, and Japan's lost decade is starting to fade into history, and bank reform has helped drive the process. More than 40 countries now boast codes or laws regulating everything from financial disclosure requirements to the structure of corporate boards. A veritable industry has sprung up around the issue of corporate governance, with shareholder rights groups, nongovernmental organizations, and rating services such as our sister company S&P, and I think in particular, George Dallas, who is also on the panel, playing significant new roles.

But there is plenty to do. European companies still have some very, very crucial issues to tackle. In Germany, for example, boards have many employee representatives, which inhibit change. Voting rights in many family run companies in Italy and France discriminate against minority shareholders. And shareholder culture is really in its infancy in Spain. In Asia, companies with truly independent boards remain rare. Too often, corporate finances are opaque, and family owners make self-serving deals with private affiliates. In China, my area of expertise, CEOs of even the best-run companies have only a murky idea of what a truly independent board member is. I know the head of one of China's leading banks, and he considered one board member, a head of a real estate empire, to be truly independent despite the fact that this person was doing real estate deals on behalf of the bank.

So I think Jason Calacanis, who sold his Weblogs Inc. to AOL last month, summed it up nicely when he said, "Adopting transparency is like getting pushed into an ice-cold lake: it sucks at first, but after five minutes, it's invigorating." We have a lot of invigorating panelists, so let's get started. I'd like to turn this back over to Hal Scott.

Hal Scott: I want to start with a general blanket disclaimer. Everyone on this panel is expressing his or her own point of view, which is not necessarily the view of the organization they represent. Corporate governance is a matter of global concern—that's obvious. You have large, public companies that operate globally and have worldwide investors. Today, we will examine three issues about corporate governance: requirements for the roles of independent directors and audit committees and outside auditors; and the rights of shareholders. Two general questions are whether there is international convergence overall on these issues in terms of standards, and whether the U.S.—the world's most important global capital market—has gotten corporate governance right or wrong.

The first topic we're going to look at is the independence of the board of directors, and particularly, requirements around the world as to a majority of independent directors. I'm going to sum up the rules of the countries represented here as to this issue.

Domestic companies in the U.S. must have a majority of independent directors under the exchange listing rules. Foreign companies that operate here can either comply with that or not. If they don't, they have to explain what they do.

Europe, of course, is made up of a lot of different countries; I'm only going to hit on some high points here. In the U.K., it is the matter of best practices in the U.K. governance code that there be a majority of independent directors. It's not mandatory; companies can comply or explain. In fact, most do comply. There's a lot of peer pressure. Germany under its corporate law has a two-tier board system. The top, supervisory board has all outside directors, but not necessarily all independent directors. Indeed, the corporate governance code of Germany suggests that there be an "adequate" number of independent directors on the supervisory board. It does

not insist on a majority, and that reflects the fact that stakeholders, such as labor unions, have representatives on the board at the supervisory level. In France, again, it's a best practices regime, with the suggested best practice that half be independent, and again, comply or explain. Italy, its best practices to have a "sufficient" number of outside directors. With respect to the EU, there is a nonbinding recommendation that there be a "sufficient" number of independent directors to assure conflicts of interest are adequately managed.

Japan has a two-tier system. The top tier is a board of statutory auditors, which today requires one independent director. This board sits on top of the management board which runs the company, a little bit like Germany. As of 2006, there must be a majority of independent statutory auditors on this top tier. Now, companies in Japan can—and 107 have—choose a one-board system, but with the requirement that the audit, nominating, and compensation committees all be entirely composed of a majority of independent directors. But under this alternative system in Japan, you don't have to have a majority of independent directors on the overall board. In China, there is a two-tier board. The top board is the supervisory board. I think the real power in Chinese companies is exercised through the state, which has a majority or a supermajority of shares in most state-owned enterprises, and exercises its control through a holding company, which is the entity that holds all of the Chinese state's shares. The lower board of the company, the management board, is required under Chinese law to have at least one independent director, but if it lists in Hong Kong, under the Hong Kong listing rules, it has to have three.

The first issue we want to start with today is independence itself. What does this mean? Is it a meaningful concept? The NYSE in the U.S. provides a very extensive definition; I know the EU recommendation tries to define this as well.

I want to focus our discussion with a case that has been in the news recently about the former Dean of my law school, Bob Clark. He is a director of Time-Warner, and he has also recently become a director of Lazard. I want to focus on whether he is truly an independent director of Lazard. I'm just telling you what was reported in the press. Let's assume for pur-

poses of discussion, that he's a long-time friend of Bruce Wasserstein, who is the head of Lazard. Let's also assume that Bruce Wasserstein was on, effectively, the board of the Harvard Law School, and that Bruce Wasserstein contributed to Harvard Law School during this period that he was on the board. He may still be contributing. It's also the case—again, reportedly—that Bruce Wasserstein helped Bob get on another board prior to Bob coming onto the Lazard board. By the way, Bob's a friend of mine. One couldn't ask for a person with more integrity and more knowledge about corporate governance. He's an authority in the U.S. about corporate governance. But the question I want to ask to the panel here is: He meets all the NYSE rules as independent, but is he really independent? Paul, how would you think about this?

Paul Atkins: First, I want to add that everything I do say reflects only my views, and not those of the SEC or my fellow commissioners.

Independence is a state of mind. I haven't actually been following *The New York Times* and other papers since I've been in Washington, so I'm not sure what's been reported up here and I wouldn't want to comment on those matters.

Recently the role of directors as monitors has grown in importance in the public realm. If you look all the way back to Adam Smith in 1776, in "The Wealth of Nations," he was writing about limited liability public companies. He didn't like them at all, and basically thought that the government should not allow them and should not grant them liability protection. He thought that the only two things that were good were sole proprietorships and partnerships, because they provided the unified interest of management and ownership. As ownership has dispersed, the role of directors as monitors has grown in importance. But we also have to remember that they are advisors as well. So both hats are important, and in this particular instance, I guess that I leave that to the shareholders and the marketplace to decide that.

SCOTT: Now Pierre, you have an EU recommendation that's attempted to define independence. I'm sure Bob Clark would meet your independence rules as well those of the NYSE. I haven't parsed them as extensively, but can we really capture independence through rules?

Pierre Delsaux: No, that's exactly the point. The approach in the EU community is slightly different because we don't have precise rules defining independence. We have principles, and when you look at them you will see that the definition of independence leaves the margin to the companies and their directors. This general definition needs to be applied to specific cases, and that's an assessment, an evaluation that needs to be done by the company and by the director. We have not tried to create a general definition that would be applicable in all situations. We have given examples of possible situations where we assume you don't have independence, but otherwise, it's a decision to be made—and to be made public, also—by the company or by the directors, and so on.

Another point is that the question of independence might evolve. You might be independent at one point, but after some months or years, because the situation may change, you might no longer be independent. Again, if you look at the recommendation that has been adopted, we ask companies to make an assessment on a regular basis as to what extent you remain independent.

SCOTT: Sarah, how do you react to this Clark hypothetical and the general question of independence of the board?

Sarah Ball Teslik: I think there are four brief key points. One is that independence is irrelevant. It doesn't matter in most companies in most countries because where the company is small enough the owners are actually controlling it directly. If the directors are owners, independence is not an interesting concept. So for most companies in the world, this is a boring discussion. Second, of course you can define independence, but of course only on a principles level. It's the absence of ties that would entangle your judgment. However, the tie that is most apt to entangle your judgment is your board seat itself, and so you can't get rid of it anyway. So that part of the discussion is boring, too. Third, we all know without any studies that in general, the fewer entangling alliances you have to managers, the more apt you are to make a decision that managers won't like. So in general, we all know that is good even though the studies have all sorts of problems. That conversation is boring, too. Finally, we all know that even if you are independent, is doesn't mean that you're smart, it

doesn't mean that you're brave, and it doesn't mean that you will make the right decisions. We all know that even if you do have entangling alliances, you do sometimes overcome them, as Charles Elson did with his friend Al Dunlap at Sunbeam, and do the right thing anyway. Those examples do not trump the fact that in general, it is better not to pick directors who are not owners, who have more entangling alliances rather than too few boards. So what this means in the Clark situation, is that unless there's a shortage of human beings in the world, this man shouldn't be on both boards.

SCOTT: Let me change the subject to the question of the impact of the independent director requirement on the performance of companies. I think I heard in the introduction, John, that *BusinessWeek* had had a view about this, that they thought that independent directors were going to increase good corporate governance in general. Is that still your view?

John Byrne: Yes. I don't think it's that boring. I think independent directors are one of the requirements that every investor should look for before putting money into a company. If you look at what little academic study there is available on the topic of: "Does a well-governed board result in higher returns to shareholders?" you see some mixed results. There was a study by Paul MacAvoy, an economist at Yale University, who looked at the companies that were considered well-governed by CalPERS. Incidentally, a majority of independent directors would be one of the central characteristics that CalPERS would look at. He discovered that these companies generally returned 1.5%-2% more to their shareholders on average every year. So over a decade, you're looking at performance that would have 15%-20% higher returns than companies that are considered to be poorly governed.

McKinsey asked institutional investors: "Would you pay a premium for a company's stock if you considered the board of directors to be independent, if you considered the board to be well run?" McKinsey found that institutional directors said they would pay an 11% premium for that stock. Directors said they would pay a 14% premium. CEOs said they would pay a 16% premium.

SCOTT: Jay, what is the empirical evidence on this question?

Jay Lorsch: John obviously didn't get to the end of the MacAvoy study, because at the end of the study, there is a disclaimer saying they don't know what's cause and what's effect. So it is entirely possible that good companies have good corporate governance because they can afford it rather than it having anything to do with their performance. I think some of your colleagues, Hal, and some of mine have reviewed most of the evidence that's out there and they've found nothing that's compelling that shows any connection between corporate performance and the state of corporate governance in any company anywhere in the world. That's what the academic studies show. Does that mean that we don't think corporate governance is important? No, not at all. But I think what it really suggests is that there are a lot of other factors that are more compelling to the performance of companies than the state of the board or the state of the governance around it.

I think corporate governance is there for a different reason. I think it is there to make sure that the company is headed in the right direction, and that it is complying with applicable laws, regulations, and ethical standards, and so on. That's really the role of directors. If the company's performance is not good, you're probably going to blame that on management first, or on the fact that they've chosen a bad industry in which to compete. So the board is there; the board has an important function, I would argue. But I don't think that the chase to find some connection between corporate governance standards and corporate performance is going to get us anywhere.

SCOTT: Dr. Breuer, you're chairman of the board of supervisors of Deutsche Bank. From your own personal experience, do you think that the participation of outside directors on your board enhances the performance of your company?

Rolf Breuer: Absolutely, in general terms, but I have to focus on the fact that independence from the viewpoint of a financial institution with a wide range of customers is different than if you are an automotive manufacturer. It's necessary that most of the members of the supervisory board are customers. And I'm glad they are customers because they can contribute more to a strategic discussion from their own experience and point of view rather than anybody very far away from the corporation.

So independence in mind is different from independence in appearance; that is the principle we have. “Independent” means preventing conflicts of interest, and that is a matter of personal judgment, and it’s a judgment of the board. Thus far, we have not run into extreme difficulties in this regard. It’s a credit to one of the members of the board—if either his firm or individual is dealt with and discussed, he does not participate either in the discussion or in the decision-making, and he does not receive the preparatory papers and the documentation. We make sure that he is not involved, and that we all—including him—avoid a conflict of interest.

On top of that, banks in general live in a highly regulated environment. So far, it is a question—what skills and capabilities do you ask for when picking the right member for the supervisory board? Should he be an expert in domestic and international banking regulation? Of course he can’t, because it would reduce the number of people. So we have the custom that former executive members join the board after retirement. That is against the rules of corporate governance in Germany. I am one of the biggest visible sinners because after I retired from my role as CEO, I immediately became the chairman of the supervisory board. So now I am controlling the bad deeds I initiated in my time as a CEO and find them brilliant, of course!

But, to put joking aside, that is one of the conflicts that you have to master and have to get a grip on. It would be wrong for a supervisory board of a bank to not have a banking expert as chairman and maybe one additional member. But that is enough. You cannot get an expert from competitor banks, neither active nor retired—that doesn’t make any sense at all. So we must really look for somebody out of our own crew to replace me, I guess.

SCOTT: Eric, from the viewpoint of an investor in companies, what is your view about whether independent directors are really increasing the performance of these companies?

Eric Roiter: I think the jury is very, very much out on that. Obviously, as an investor, what we’re interested in is economic returns, and we’re going to be open to any factor, any approach, any strategy that is going to have any impact that could enhance the prospect of greater economic returns.

But if I had a wish list, I would put at the very top not eliminating the phrase "independence" or "independent directors," but subordinating the phrase and the concept to another phrase and concept, and that is "dependence"—"dependence on shareholders," or "responsiveness to shareholders." Independence is a neutral state. It doesn't tell you anything about whether that individual or group of individuals is going to add value or will help shareholders achieve economic returns.

If you really think about where that dividing line is between dependence and independence, it actually starts with two concepts. Think of a CEO: A CEO is the paradigm of somebody who is not independent. Why? I would suggest two factors. How much is that person making? How much money, how much wealth is that individual extracting from the company? And is it his or her full-time job? Now consider an independent director, and just ask yourself: Are there any constraints or any real limits on the amount of compensation that an individual can make serving as a director? You have a compensation committee consisting of independent directors. They basically set their own compensation. And OK, best practices? Sure.

Second, the question is how much time? If there is a trend, it's a trend and a best practice toward spending more and more time as an independent director. I'm not aware that it would actually rob one of independence if one decided: "I'm going to actually get office space at this company. I take my job as independent director so seriously, I'm going to go there every day. I'm going to read everything I can."

So I would not eliminate reference to independent directors. I would not totally obliterate the notion of independence, but I would subordinate it to a higher notion, and that is dependence on shareholders, responsiveness to shareholders.

SCOTT: Let me change the discussion a little bit. The question is: Do the stock exchange requirements for a majority of independent directors really make sense for the rest of the world? Would a U.S.-style majority of independent directors rule make sense in the German context?

Jochen Sanio: I think Mr. Breuer has already made it very clear that, with our two-tier structure, we have a quite different approach. And I fully share his

view that the main thing I want to see in a supervisory board—which in our case has to take on a role more or less akin to that of independent directors—is experience. What the U.S. concept certainly does is avoid conflicts of interest by applying the force of law. That is something that is essential. I think that's the right area for lawyers or legislators to have their say. But I think that is as far as things can be taken down that road. As has already been said, the real point is independence of mind, and that is not measurable. That is a holy grail, and how near you will come to attaining it will depend on the circumstances. Conversely, the worst thing would be to see people becoming too independent from the company, and standing too far back. People have to identify with the company, and give it the benefit of their experience.

I would like to add another point from my own perspective as a supervisor. What I have seen for years, not to say decades, is not so much the question: "Can these people enhance the profitability of the company?" My question is much more basic: "Can these people prevent the company from going under?" I have seen several cases where these people were weak, and you could say "weak" is the same as not being independent, in the sense that they were not able or willing to stand up against the CEOs. It is my textbook case that the greatest risk of a bank or an insurance company perishing is a dominant CEO who is not controlled by the supervisory board. That's my prime concern. All of the other things that have been said sound to me, as a European, rather academic.

SCOTT: I think in the German supervisory board context there are stakeholders, particularly the unions, who have a role on the supervisory board. I think that then reflects the reason that Germany does not have a majority requirement for independent directors on the supervisory board: Other outside directors who may not be independent have a role to play in the German corporation.

Guido, if you look at the rest of Europe—I know that's a big assignment—does this U.S. requirement of a majority of independent directors make sense?

Guido Ferrarini: Yes. To me what really matters is the ownership structure of a company. The majority requirement makes sense for diffused shareholder

companies like the American corporations, whereas in Europe, for instance, the majority of corporations will be controlled companies; companies in which there are controlling shareholders. In this kind of situation, a lot of the monitoring is done by the controlling shareholders, either directly or through their representatives on the board. Therefore, the board structure, which is common and widely accepted in Europe, is one in which you have executive directors and nonexecutive directors who are in some sense representative of the controlling shareholders. Then you have independent directors, and these independent directors will take care mainly of the conflicts of interest between majority shareholders and minority shareholders. They will be also nonexecutive directors like the others, and will act in this role. To conclude, there are some companies/corporations in Europe in which you have a majority of independent directors, but these tend to be companies in which there are no controlling shareholders.

SCOTT: Europe has more different structures of ownership than the average U.S. company, which is very widely held. In Europe, we see a phenomenon more of dominant shareholders, and this of course picks up Eric's point: Maybe you want more shareholder control rather than less, and if you have that shareholder control, you don't need this independent board of directors.

Mat, in looking at this independent directors requirement from a Japanese point of view, is this something Japan needs to have, or is Japan also different from the U.S.?

Masatsugu Nagato: Yes. In Japan we have two structures. We used to have only one, which is the conventional Japanese structure. For those corporations, we do not call them "independent directors"; we say "outside directors". They may not be independent.

A new structure was introduced several years ago, I think definitely influenced by the U.S., and this is called the companies with committees: nomination, audit, and compensation. The U.S.-type structure has been adopted by only 107 corporations; a small minority among the several thousand listed corporations. And even in these corporations, we do not require that the entire board have a majority of independent directors. The majority directors concept can be applied only to each individual

committee. So in each committee, a majority of the number of directors must be from outside.

But there are several dilemmas. Even though we tried to keep independence for those new concept corporations, you mentioned performance. These are the statistics from a research firm. Among 107 corporations, 31 corporations answered. From 2002 to 2004, the average increase of revenue by those companies with committees (U.S.-influenced corporations) was 7.1%. But the average increase of revenue by all other corporations, about 2,000, was 9.2%. So performancewise, in revenue, U.S.-type corporations did worse than the traditional Japanese ones.

SCOTT: This is sort of in line with the Lorsch, as opposed to the Byrne view.

NAGATO: Right. And the profit, the EBITA of these corporations with committees is 36.9%, while the other corporations have shown 51.7%. So unfortunately, performancewise, these independent directors corporations are not doing very well, and for several reasons. Number one, outside directors may not have experience in those corporations, and even though they are from outside, many times they are the retired CEOs of other corporations who have been very good friends of the current CEO of this corporation. So even though they are from outside, they may not be giving good advice or guidance to the current management team. This might be the reason why.

SCOTT: And would it be fair to say also, Mat, that at least historically, Japan has had other techniques of control of corporations? Somewhat like Germany, the banks historically played a very central role in corporate governance of corporations within Japan. Second, you’ve had this cross-shareholding system after the war, the *keiretsu*, which replaced *zaibatsu*. And so the cross-shareholding of Japanese corporations, which has gone away now to a large extent, was also a vehicle of control. These two traditional methods of Japanese control are going away. The question remains what will replace it in Japan?

NAGATO: Right. I agree with you. For example, the total lending amount divided by GDP in Japan is currently about 80%. It used to be more than

100% in Japan, so banks were in a stronger position in the past. At the same time, Japanese banks are allowed to own stocks of corporations. So they are both lenders and shareholders. So, corporations tend to listen to the banks a lot.

We used to have a cross-holding system of shares. Even though that situation is now changing gradually, it's still there, especially among *keiretsu* corporations, such as Mitsubishi Group. There are many corporations that hold shares of each other. So they tend to listen to those holdings. This might lead to a better corporate governance situation.

SCOTT: George, from a creditor's point of view, Standard & Poor's point of view, when you think of the importance of this independent director requirement, how do you see it?

George Dallas: Well, my reading of the academic literature would correspond with Jay Lorsch's. Much of the research has been conducted from a shareholder's perspective, asking the question whether there are superior returns linked to independent directors and other aspects of board structure. There are some methodological issues with regard to how some of the research studies have been conducted, but there is not a lot of evidence that independent directors are linked causally to superior equity returns. I could cite some specific cases in emerging markets. Bernard Black, for example, has done interesting research in Korea and Russia—places where board structure might actually have a more substantive impact. But here in the U.S., I would say the formal evidence is questionable.

So maybe it's still an open question as to whether independent directors and good governance structures create value. However, the flip-side question is whether bad governance or perhaps the absence of independent directors can destroy value or increase financial risks. This more downside-focused question has relevance to both creditors and shareholders, and here I think we're on more solid ground in terms of linkage of governance to investor interests—as we're all aware of individual cases where we can see, at least on an ex-post basis, how poor governance structures have contributed to value destruction.

We don’t want to tout independence too highly, and I think industry experience, even if that comes with the baggage of not being independent, can still be a very good thing in many cases. I would also endorse Professor Ferrarini’s point about ownership structure, because I think particularly in the U.S., we don’t think about this that often because our companies and our whole philosophy about governance is framed around diverse shareholdings. A statistic that you didn’t mention, Hal, is that even in the NYSE listing rules, if you have a controlling shareholder of more than 50%, this independence requirement is waived.

SCOTT: It’s a pretty high level.

DALLAS: Yes, it is. Where you draw the line is important. But the point is that it’s still an issue, even in the U.S. The independence requirement that you speak to is not necessarily true in all cases.

SCOTT: Well, given all of this, I think another big difference between the rest of the world and the U.S. is whether this independent director rule should be mandatory or optional. In the U.K., it’s optional, but peer pressure makes it almost mandatory, by practice. In the U.S., we take an optional view toward the non-U.S. companies when they come here. We say, “You can comply with this rule, or explain why not.” But our domestic companies must comply with the rule. Would we be better off with the “comply or explain” European approach for our own companies, or are we be better off with a majority requirement? Dick, what’s your take on that?

Richard Kilgust: Well, it’s an interesting question. One of the big questions here is even if you want to regulate everything to death, at the end of the day do you still have a truly independent board? And the same thing also goes for auditors, by the way. Board members are paid to sit on the board by corporations; auditors are paid by the corporations they audit. So you can put in place many regulations and rules, and we have done that with respect to auditors, but does that necessarily guarantee this whole notion of independence?

There is a real role here for transparency in terms of describing what you’re doing and why you’re doing it. We’ve already talked about diversity that’s

created not only in terms of where you sit in the world, but also even in the U.S. in terms of what your stakeholder group is made up of, which argues, at least in my mind, for a model that's probably somewhat more flexible. And this whole notion of comply and explain is a good model if you have people that are explaining with a sufficient degree of transparency.

SCOTT: The NYSE's explain requirements are pretty brief. They want a couple of paragraphs. My impression of the rest of the world is that there's more content to the explaining than just a couple of brief paragraphs. The question would be, if we have "explain," how much explanation should we have?

KILGUST: Well, again, you don't want to have a rulebook in terms of describing how you explain. But you probably have to have some framework in terms of: "What are the important ingredients?" If the makeup of a stakeholder group is important in your decision, then that should be something that should be addressed in this whole notion of explaining. If it's heavily made up of owner-operators, and therefore the true external stakeholders are a true minority, that may then instruct you in terms of what type of board you have, and you should be explaining at least along those lines.

SCOTT: Elaine, I haven't gotten to you and China, but would it make sense to impose a majority of independent directors requirement in China?

Elaine La Roche: I think that might be difficult, especially when we're dealing with large, state-owned enterprises in a culture where perhaps independent thought is not a hallmark. I think that you would find this to be a great challenge. That said, in the emerging private sector companies, where many are in fact more likely to come into the U.S. marketplace, I think the rigor of independent directors, at least at the outset, would be quite useful. I think when we think of China, we have to remember that we're not just talking about new concepts of rules and regulations; we're also talking about new concepts of organizational structure. So understanding what is the role of a board—or in the case of financial institutions in China, what's also the role of the supervisory boards—even comes before the actual practice of the participants on these entities.

SCOTT: So is anybody on this panel in favor of mandatory rules for having independent directors? I sense there is kind of a consensus that it would be better to have a comply or explain approach, so long as we adequately explain what we're doing. Pierre?

DELSAUX: I would like to make a point that is linked to the question of "comply or explain" principle. You say comply/explain functions in the U.K. because of peer pressure, but not only that. You need to have also a real endorsement of shareholders, because the question of comply/explain is also linked to the issue of enforcing this principle. Peer pressure is certainly one means to achieve compliance with comply/explain. But also giving appropriate rights to shareholders is fundamental from this point of view, because if shareholders are not able to ask for explanations from the board, and are not able to sanction the board if they don't comply with the explanation, then you might not achieve a real comply or explain system.

SCOTT: Let's move on to our second topic, which is the role of the outside auditor and the audit committees of corporations. I will give a brief overview of what the rules are on this subject around the world. U.S. public companies must use an outside independent auditor, and there is an extensive definition of what independence is. This auditor must be hired, report to, and be responsible to an entirely independent audit committee composed solely of independent directors. Under the exchange requirements (listing requirements not under Sarbanes-Oxley) this audit committee must contain at least one financial expert, and all of the members of the audit committee must be financially knowledgeable, as determined by the issuer. In addition, we have a specialized regulatory agency, the Public Accounting Oversight Board (PCAOB), which regulates the auditing profession; that's also part of Sarbanes-Oxley.

In Europe there are a variety of arrangements. In Germany, the outside auditor is responsible to the supervisory board (outside directors) but there's no specialized agency in Germany like the PCAOB that regulates auditors. In countries with single-board systems, there is generally no requirement that audit committees be entirely composed of independent directors, and most countries have no PCAOB. Some do, I think, but it's very limited. The EU recommends that there be a majority of independ-

ent directors on the audit committee, but that's a recommendation, not a binding rule.

In Japan, the outside auditor would report to the top-level board of the statutory auditors (composed of a majority of independent directors), or for those companies that have opted for American-style committees, to the audit committee, which is also composed of a majority of independent directors.

In China, for large, state-owned enterprises with public ownership, there are audit committees, but there is no requirement that the audit committee be solely composed of, or even have a majority of, outside directors. However, if a Chinese company lists in Hong Kong, there's a requirement that the audit committee have a majority of independent directors, and that the chair of the audit committee be independent.

We have a wide range of approaches to the role of the audit committee. It's generally the case that all companies must have independent outside auditors. So let me now ask: Sarah, are outside auditors truly independent?

TESLIK: As Dick Kilgust said, someone has to hire the auditors, and assuming that the body that hires the auditors is either corporate managers or the board of the directors, the auditors, if they have any brain, will have an interest in keeping that work, and have an interest in keeping the company happy. However, I think that one of the improvements that Sarbanes-Oxley makes—which is one of the two things that I actually supported in Sarbanes-Oxley—was that the board of directors be required to hire the outside auditor rather than the managers. It is not a magic bullet, but it is an improvement because there is a chance that if the auditors find inappropriate behavior on management's part, they have a shot at keeping their job, not losing it, if they report it to the board. If the board is composed of people with a reputation to lose (which for me is the number one criterion of who you put on a board), those people will want to listen to the outside auditors and fix the problems because otherwise their reputation is at stake. You can, of course, make the outside auditors more independent by not having them hired by the company, and hired by the government or some other body.

I think all of those alternatives are worse, and so given that once you have a contractual relationship, there is an alliance, the best you can manage to do is to require that the board hire outside auditors. Again, it's not a magic bullet, and I'm sure we'll now go over all the problems with that, but it beats the alternatives, which are management or some outside body.

SCOTT: Now Jochen, your agency regulates financial institutions, and you have more than a casual interest in the question we're raising, because you are heavily dependent on the outside auditors to protect the German financial system, given the systemic problem with bank failure. So you have had a lot of dealings with auditors. Are these auditors independent when they examine the banks?

SANIO: Sometimes I think I'm running a defense network as a supervisor. And the first line of defense is the supervisory board. And as important, or maybe even more important, are the auditors, and not just for the sake of supervision, but for the sake of the financial institution itself. The role of auditors is of primary importance, and in the German supervisory system we rely on the information and evaluations provided by the auditors, not only in the traditional areas of recent decades—profits, development of the business—but also these days, with the new supervisory approach, assessment of the risk management and control systems of a financial institution. So as you said, the question: "Are auditors really independent?" or I would even go one step further: "Do they have the opportunity to be independent?" is a very fundamental one.

SCOTT: And what's the answer? [*laughter*]

SANIO: Auditors are in a fundamental conflict of interest situation, nobody can deny that. The question is: How can they solve this conflict of interest? They are for-profit organizations, and they want to keep their audit mandates. I'm not really talking about any nice consultancy jobs that they might do on the side, and where they might even make more money than as auditors. For all this corporate governance discussion, this is the most important point: to strengthen the role of the auditors, to strengthen their independence. My idea is very simple and clear: Put them under pressure. Start with peer group pressure, start with new institutions that have been created

to look into their work, to supervise them, and make it at least likely that the results of their work are of a minimum standard that you can rely on.

SCOTT: But in your dealings with these auditors, have you come away with a conclusion that is: "Yes, I think they are generally independent", or "No, I don't think they're generally independent?" Is there an independence problem as you see it in Germany?

SANIO: I have a habit of never answering yes or no. But I think I was rather clear. And over the years, not to say decades, I have seen cases in which auditors unfortunately did make mistakes, and where they painted a bit too rosy a picture of things, and in the end, they were taken to court. Under German supervisory law, we can debar them from examining or auditing any further institutions. But I have to be clear: in very, very few cases have we had to do this. But in general, and to avoid creating any misunderstandings, I have to say that the standard of the profession is quite high.

SCOTT: Dick, you have a personal and corporate interest in this question. What is your take on the independence of auditors?

KILGUST: I started this discussion with the fact that at the end of the day, auditors are paid by companies, whether or not that represents a fundamental conflict, and Sarah picked up on that. I think that it's important to think about that. If you're solely dependent upon a client relationship for your livelihood, I think it clearly could be a problem. Taken to the next degree, if you're solely dependent upon very few relationships, that could be a problem. Here is where size is of a great benefit. When you have great size and a great number of clients, any one of those clients in actuality represents a very small piece of whatever line you want to look at in your own financial statements, revenues, or income. Then you can clearly set aside any business at issue.

Auditor independence, though, is a topic that seems like it will never go away. It's been around for a long time, and it's something that everyone regulates these days because to a certain extent, they can. There are concerns about auditors raised with respect to all of the failures that have gone on, about whether or not you can trust what auditors are doing. Often, the

reaction to that is to regulate around this whole notion of independence. I will stipulate that independence is very, very important. There is no doubt about it. Auditors only really have a monitoring goal. If you think about boards, as we've already said, they are both there for monitoring and, to a large degree, advice. Auditors are much more skewed to monitoring. So independence is important.

But it's not the only thing. There are other things out there that are very, very important, such as skills. The auditor has to be more skilled than their clients. They have to know more about financial accounting, financial instruments, because at the end of the day, they're the professors grading papers. So they have to have the skill set. They also have to have ethics. Ethics override everything. If you're grounded in professional ethics and you understand what your role is in society, then that cuts through these more tangible conflicts.

The last ingredient, which is maybe the most important from the standpoint of an auditor, is professional skepticism. You can be entirely independent but go into a situation and try to look for things that justify what you see. Or you can provide other services but still go into that audit situation and look for things that prove that what you see is incorrect. And that's the whole notion of professional skepticism, and it's a key ingredient.

SCOTT: So I take it you think that in terms of the professional standards of the profession, ethics are an important protection against this possible conflict of interest: that you're paid to do the job; therefore, you're going to tell the client whatever they want. It's probably also true that your prospective liability comes into play there to make you a little bit more careful as well. Eric?

ROITER: I just wanted to return to the word "independence" with respect to auditors, because it really means something different than saying the word when it's used for directors. Share ownership is thought to be a very good thing for independent directors; it's the kiss of death for independence of auditors to own shares in the company which they audit, and that's because an auditor really has a very different role than a director, independent or board management. You have constituencies that you're serving that go

well beyond the equity owners of the company. You've got the creditors, certainly, and you've got government agencies as well.

This all comes down to identifying factors that move the needle in a favorable direction. None of these things are sufficient in and of themselves. I heard earlier something doesn't guarantee the outcome. Well, if "guarantee" is the test, then nothing ought to be implemented. And the question really is, is it a factor that is, on balance, one that is more likely to advance good results or to minimize the risk of bad results? In that regard, I think independence of auditors certainly is a factor that ought to go into the mix of things that should govern the work and appointment of auditors, not to the exclusion of the other things that were just mentioned.

SCOTT: Well, I think it's the case that we have a very high concentration ratio with respect to the auditing profession. The data I have shows the major four firms audit 97% of all companies with sales of more than $250 million. The question that I pose to the panel is: Is this a problem? And if so, what can be done about it? Jay, what's your take on this?

LORSCH: You know, I don't know if it's a problem, but it is a reality that we do have four big firms, particularly when you're talking about global companies, that can really provide the kind of auditing service that these companies require around the world. I'm not an economist, but I suppose the label such a person would put on this is it's an oligopoly, and it probably does create less competition than we might want. We know fees are rising, and they seem to be rising across all four firms. I'm not suggesting collusion; it's just the nature of the way the system is working. So I think it would be better if we had more choices. The reason I'm not sure it's a problem is: if it is a problem, we've got a big problem, because I'm not sure how you get around this.

SCOTT: Well, we can have some problems we can't fix! [*laughter*]

LORSCH: There is another level of accounting firms below the big four that have gotten involved. In fact, one of them was involved in Parmalat, unfortunately for them, I guess.

If we're talking about global companies the question then becomes, how do you create another competitor in this marketplace? And I think it's very, very difficult to visualize how that will happen. It's taken years and years to get the four in place, and unlike law firms, we're not seeing a lot of mergers and acquisitions creating bigger and bigger firms. We seem to be stable with four big ones, and the smaller ones don't seem to be coming behind them. So I think as an economic fact, we have to deal with the fact it may be a problem, but that's where we are.

What do you do with an oligopoly, then? Well, you can think about regulation; you can think about some things most of us wouldn't want to talk about. I just want to say one word about independence, since you didn't call on me.

We run a program for audit committee chairman, and we've probably had 200 of them through our place in the last couple years. I do not hear any of them complaining about independence of the auditors. They're not worried about their independence. They're worried about a lot of other things. They're worried about the fees going up. They're worried about the fact that these men and women won't offer very strong opinions about anything, that they won't do anything without going back to their central theory groups. All of which I think everybody can understand. But we have a profession here that is running scared. Independence is not the problem—they're very independent. The problem is they're too worried about their own hide, in many opinions.

SCOTT: Right. So where their concentration ratio goes, if I understand you, it's making them more independent!

LORSCH: That's probably true.

SCOTT: There may be collateral consequences in terms of high fees.

LORSCH: Right.

SCOTT: But since they have such a strong market position, they can stand up to the company and say, "Where else are you going to go?"

LORSCH: The only thing I would add is that the independence may not be leading them to do a better job in the view of their clients, the chairman of the audit committee and the audit committee members.

SCOTT: John, do you think we'll get new entrants into the auditing Big Four?

BYRNE: You didn't call on me either about independence, so let me just say one or two things. There are no absolute guarantees of anything. You can have a good board and not have a great performance if you're in commoditized markets with products that are not proprietary, lousy marketing and selling, and no R&D budget. And you can have fraud and malfeasance if you have an independent outside auditor that has a great reputation.

But to Sarah's point, here is what we know based on some of the blowups that we've seen at Enron, WorldCom, and Sunbeam. When management hires auditors, and the CFO and the treasurer sit in on the audit committee meeting, and the auditor is meeting with those directors, those conversations are not as revealing and not as candid as they would be if management is not hiring the auditor and management is not in the room with the audit committee. It's as simple as that. That's how it was at Sunbeam, and that's how it is at most companies.

So you deal in probabilities and things that make you comfortable. If an independent outside auditor makes me comfortable, then the probability is I'd feel safeguarded as an investor. If you have a board composed of a majority of independent directors, it makes me feel comfortable. I think the probability is that company probably will be performing better if in fact it's doing the business of dominating its category, of innovating, of being creative in a marketplace and selling and marketing at a high, world-class level.

So your point about will there be more than four auditors, heck if I know. And I'm not so sure that it's a big problem. And to Jay's point about fees, I think fees need to be much higher, because we're making higher demands on auditors than we ever have before. They need more money to do the job. We all know what one of the big problems was: auditing became a loss leader for consulting. Auditing was underpriced

in relationship to what we expected of auditors. They need to have more money for their audits, not less money, because the demands that we’ve placed on them are higher today.

SCOTT: So Rolf, from where you sit, do you think we’re going to have new entrants into the Big Four of the auditing profession over time?

BREUER: In general, of course, it is always better to have more competitors if you are the user. But that is a very general approach. Judging from my experience on globally active corporations, to have different auditors in different countries for one single corporation is a nightmare. I remember a case where we had a Brazilian auditor for the Brazilian entity, an Indonesian auditor for the Indonesian entity, and an auditor in Germany. It was unacceptable. So I think there is a necessity that yes, it would be nice to have more of a choice above and beyond the four big ones, but the rest should be internationally competitive to really service a globally active corporation.

SCOTT: So you don’t see new entrants into the top four in the new future?

BREUER: I have great difficulty imagining that somebody will be able to, in the case of Deutsche Bank, audit 75 companies in 75 different countries.

SCOTT: The problem is worse than having the choice of four. With respect to certain industries, there’s specialization within the auditing profession. For instance, in oil and gas, you can only choose two. Let’s suppose one of those is your consultant—you can only choose one. So we’re maybe not just talking in particular cases about oligopoly: we’re talking actually about potential monopoly. So Dick, how do we deal with this problem if it at all?

KILGUST: Well, I think the important thing is to not put in artificial barriers that would inhibit the marketplace in terms of letting entrants have an opportunity. Other than that, I think you have to let the marketplace work. I mean, the fact of the matter is if you took the next 10 largest auditing firms and you rolled them up into one firm, that firm would still be a quarter of the size of the number four firm. So there is a very wide disparity, sizewise, and also there’s a wide disparity in terms of the network and international reach of those other firms. So this is an issue that you look at

that the market opportunity here is probably limited, but on the other hand, I don't think you should make it more limited by other factors.

SCOTT: Some people have speculated that one of the reasons that we have such high concentration is the liability of the auditing profession, which leads to maybe economies of scale regarding liability. I don't know that that's true. I do know, however, that the EU has begun looking into the question as to whether there should be some way of capping auditor liability, whether some forms of limits should be placed on that. Pierre, could you give us your thinking from the EU's point of view as to why you're going off in that direction?

DELSAUX: This is a question for the market to decide, whether you will have new entrants or not. But we have to see whether some regulatory obstacles create a problem for new entrants. One fear and one question is: Are we going to have more companies as global players, or are we going to lose one of them? Because the situation could even be worse if we go from four to three, or even to two, and we finally get a situation of a duopoly or an oligopoly. So that's a fear that we have in Europe: that the market will go down.

SCOTT: By the way, an interesting comment if I may interrupt you a second, but it was interesting to me that in the KPMG episode, the question of concentration for the world was basically left to the Justice Department of the U.S. So if the Justice Department of the U.S. had behaved in a similar manner to the Anderson case and actually criminally prosecuted KPMG, this would not have had an affect on only the U.S., it would have had an effect on the entire world.

DELSAUX: Exactly. That's the point, because something that occurs in one country, especially the U.S., might have an effect everywhere in the world, and might affect all markets in the world, and that's something you have to take into account.

Now, on this question of liability and the possibility of finding solutions to limit liability in Europe, first of all we are now in the process of adopting new legislation on auditing in Europe which basically would explain and

organize the statutes of audit in Europe, and which would force companies to have an audit committee with one independent member. In all member states we will organize the equivalent of PCAOB. One of the aspects of this directive is the question of limiting the liability of auditors. We are going to launch a study to see to what extent it's possible, how to do it, and what could be the consequences of such a limitation of liability on the number of firms being present in the market.

Whatever we say in Europe, we have to realize that this is a global issue, and even if we are able to come up with a scheme to limit liability in Europe, if you still have a major problem in the U.S. and one of these firms is affected by a liability problem there, that will have consequences in Europe. So whatever we say in Europe, this should be a global discussion with all players being present.

SCOTT: Sarah, the idea of limiting the liability of the outside auditor, do you have any thoughts about that?

TESLIK: I have thoughts on every subject.

SCOTT: [*laughter*] Is this boring, this topic?

TESLIK: No, this is interesting! And this is actually interesting because of the details. Although the aggregate number of dollars given out in auditor liability settlements is large, the percentage of losses that investors recover is small. Now that is in part because virtually no one ever maintains that auditors start the fraud. It's always mystified me that in Sarbanes-Oxley, so much of the text focused on auditors when no one ever suggested that they were the starters of the fraud, and no one ever has suggested that they are the first safety net. The board is, and yet the boards are largely absent from Sarbanes-Oxley.

Having said that, I think the balance of policy issues with regard to auditor liability caps comes down to the particulars, and that it is probably fair to offer liability caps to auditors in exchange for certain things that are good public policy such as the auditing firms agree themselves to have independent bars, that they exempt from the auditor caps anything that is reckless or intentional. I think those things have to be eliminated. Potentially, there

should be mandatory rotation every 10 years, and I know this is a big gap for the average individual investor, but the auditors agree that it is their job to detect fraud if it is material. I think the average individual investor—and they're still half the market in the U.S.—believes that an auditor's job includes detecting fraud, and the average auditor will tell you that that is not true. They're there to make sure the books are kept in accordance with accounting principles. So if it's material and you come across it, and you agree that it's your job to make it public, then I think caps on liability are fair and probably good public policy. So I think this is one where the interesting and non-boring stuff is in the details. It's probably good public policy; it just has to be worked out.

SCOTT: Rolf, from your position, do you think it would be a good idea to limit the liability of the outside auditors? Is that a solution to the concentration problem?

BREUER: I don't think so. It is sort of strange to the system that you start thinking about that as an instrument to come to grips with the problems we just discussed. I think that, as we used to go about things in the past and continue to go about it, this has improved thanks to the scandals and rackets, or the reaction to the scandals, judging from my own experience, specifically in Germany. The more active parts of the audit committee are composed entirely of independent members and not chaired by the chairman of the supervisory board or a financial expert; financial literacy is a general goal for all members of the audit committee. This more active role of the audit committee has changed the old habits for the better. It is no longer some sort of a tit-for-tat between the auditors and management, and compensation issues, and so on. In Germany, both the selection and remuneration of the auditors is done by the audit committee, so the auditor has a quite distant relationship with the executive management. And that definitely allows for more independence. If you have a very active chairman of the audit committee who challenges the auditors and asks the right questions, then you get much better results.

SCOTT: Right. But maybe we've got too much independence of the outside auditor because of the market position of this outside auditor. And we've looked at new entry as a possible solution. People think that's not very likely. So then, we come along with this different idea that maybe if we

made auditors less liable or limited their liability in some sense, we'd get more new entrants into the profession. But I take it you're skeptical that that would happen?

BREUER: Yes, indeed. I don't think there is a direct correlation, and that limiting the liability brings better results than we have gotten in the past couple of years, anyway.

SCOTT: Jay?

LORSCH: I do not think that, but what really worries the auditors is the possibility of being put out of business like Anderson was. I don't think insurance is going to help you. But I also want to agree with Rolf's point. I think that the key to making Sarbanes-Oxley work is competent, hard-working audit committee chairs. And those people are working hard. The law has worked in that respect very, very nicely. And so I think that has really given the auditors a new client, and that's changed the name of the game. So I feel pretty good about what that law has created in that respect.

SCOTT: I might say in terms of Pierre's thinking on this that a parallel might be that in the U.S. in the mid-1990s, we were very concerned with the possibility of the liability of the outside director affecting the ability of corporations to hire outside directors. We're again worried about that with WorldCom and the personal liability of outside directors.

One of the responses to that in the U.S. was to cap the liability of the outside director by changing the legal standard for the liability of the outside director by requiring a showing of some kind of recklessness. It's not just a question of negligence. Second, we made them proportionally liable for whatever damage they caused, not making them jointly and separately liable. These are legal techniques that have the effect of limiting the liability as opposed to saying, "You can only be liable up to an insurance policy limit," or "You can only be liable for $1 billion." This is changing the legal standard.

Any reaction to that approach with respect to the auditor? Somebody said that the auditors didn't start or cause these frauds. They might have been

complicit in them, and they might have failed to discover them, but they weren't starting them. And I think it's that kind of point of view, plus the concentration concern.

Let's now turn to the third subject that we have today, which is the question of shareholder activism. This is a very complicated subject; there are many different rights of shareholders. It's hard to summarize them all. I think it is clear to say that the U.S. in general has been more restrictive about the rights of shareholders than many other countries.

Guido, How would you compare the rights of shareholders generally in Europe with the U.S., and why might there be such a difference if there is one?

FERRARINI: In Europe, under European law, shareholders have more powers than here. But you should correlate this to the fact that in Europe, most companies are controlled companies, and this makes a difference, of course. First of all, controlling shareholders want to have powers with respect to managers. Second, even if you give powers to shareholders, there isn't any serious risk of the minority shareholders using those powers because the majority will rule in the general meeting in terms of board elections. In assessing shareholders' powers, you should not forget what is the main ownership structure in a given country. And from a European perspective, there is no doubt that if we read U.S. law, we are sometimes shocked to know that there are little powers, for instance, in terms of board elections. This whole discussion about plurality voting or majority voting is a discussion that we don't have in Europe because for us, it is quite clear that there is a rule of majority voting.

SCOTT: Just to underscore Guido's point, I have a little data on this. A study done by Professor Ronald Gilson showed just this one shareholder owns 64.2% of companies in Germany, 56.1% in Italy, and more than 66.6% in Asia. I don't have the U.S. number, but I would be shocked if it was anywhere close to those. So this just underscores Guido's point of a very fundamentally different structure of concentration of ownership in shareholders in Europe as compared to the U.S.. And need we talk about China? There, of course, we have a dominant shareholder, who is the state.

Commissioner Atkins, would we be better off in the U.S. moving to a different system, or does our system fit us well if we have this sort of dispersed ownership system? That is, in a dispersed ownership system, would it be better to constrain the shareholders more than it would be in a concentrated ownership system?

ATKINS: The question comes down to what’s the role of the federal government versus what’s the role of the states? Historically, in the U.S., we have left all of this governance to individual states to work out, the theory being that you have this amazing group of 50 different jurisdictions, and let’s try different ways of doing things. Then you layer on top of that the listing standards of the various stock exchanges. So maybe we’ll have more innovation. We’ve become a much more global marketplace. From my perspective, I would much rather see these sorts of issues worked out in the marketplace.

SCOTT: I take it when you talk about the marketplace, this decision of shareholder rights should be largely left to the states?

ATKINS: Well, I think so. And I think that’s our system. Even when we put out our shareholder proposal back in 2003, one of the big issues was does the SEC have the authority to allow shareholders to vote for the one or two or three board members?

SCOTT: If you were the state Commissioner of Securities, do you think that the Delaware system for shareholder rights, which is pretty limited compared to many countries in Europe and the rest of the world, I would say even Japan, is appropriate for U.S. companies in general?

ATKINS: State law sets up a compact between owners and management of the company. There is no reason for state law to limit the forms that such a compact may take. In addition to the limited liability company, there should be room for limited liability partnerships and other innovative arrangements that allow shareholders to exert varying degrees of influence on management.

SCOTT: So if I understand correctly, in your model we have 50 states, and we should let the market decide? If a company incorporates in Delaware and

that's not the right balance of shareholder rights, there'll be a market effect to that because some other state would give shareholders more rights, and then companies would be forced to incorporate in that state. I mean, that's been our traditional view of competitive federalism in the U.S. with respect to corporate law. The question is, does it work with shareholder rights? Eric, what do you think?

ROITER: Without making a value judgment about Delaware, it's their industry, and as a shareholder, you don't have a line-item veto. "Gee, I like this company except for the fact that it's incorporated in State X, so therefore change your domicile and I'll own you, or I'll buy more of your shares." It's one of innumerable variables that an investor has to weigh when making an investment decision. I would suggest that it's not at the top of any investor's list when looking across the 50 states. So do you have effective competition among the states with regard to corporate standards? I haven't studied it that closely, but I would hazard the guess no. You have a recognized industry leader in Delaware, and other states that want to attract corporations tend to pretty much follow the lead of Delaware.

But if I could say a couple of other things about shareholder rights/shareholder activism. The very phrase "corporate governance" is a misnomer when you apply it to shareholders. The metaphor to political government is a very imperfect one. It assumes that shareholders are like citizens, but there is a very fundamental difference is at least two respects. Number one, citizens have obligations as well as rights, and minority shareholders really don't have any obligations to one another. I'm speaking about affirmative fiduciary obligations. They have negative obligations. They can't defraud others in the marketplace; they can't manipulate securities. But they can act in their self-interest, their naked self-interest, and they have no obligation to promote the welfare of others so long as they don't violate disclosure laws. Coming from a mutual fund complex, we owe our fiduciary duties to another constituency, and that is the shareholders that invest in our funds. That's a real question about how you actually frame the context around shareholder rights. "Corporate governance" is not a particularly useful metaphor to use.

From the standpoint of mutual funds, we are constrained in what we can do. While people speak of involving institutional investors as activist

shareholders, in fact, if you go back to the origins of the Investment Company Act of 1940, the Populist underpinnings of that statute very much look to constrain the involvement of mutual funds in the corporate affairs of companies. So you have diversification requirements. You actually have effective constraints if not prohibitions on acquiring control, exercising control, or even controlling influence. That’s been the paradigm for mutual funds: to be passive investors. This is a continuum. There is space on that continuum from being an entirely passive investor to being one that is seeking control. Those who are looking to institutional investors, particularly mutual funds, as the next best thing in corporate governance in terms of promoting better results for all shareholders have to appreciate the limitations on that approach.

One more thing on corporate governance. People have this notion that if investors are like citizens, then shareholders are like citizens, and there’s one day in the year that you get to vote, just as every four years you get to elect a President. But I have to tell you, our fund managers don’t circle a date eight months away to say: “Ah-ha! I’m going to circle that date. It’s now December 6th. I just can’t wait till May 12th rolls around, and I’m going to vote to withhold.” Our fund managers are actually voting every day by buying and selling equities in the marketplace, and that’s an election that happens with real, immediate impact. I don’t think nearly enough study has gone into how the marketplace itself, how the trading, the secondary markets, and equities, actually impacts corporate governance.

SCOTT: Let’s talk about some specifics, such as the possible right of shareholders to nominate directors, which has been a hot topic these days. I was always told that shareholders have very little ability to nominate directors, that they have no right to put their nominations on the corporate proxy statements. That was really the whole issue with respect to the proposed SEC rule, which was shareholder access to the corporate proxy mechanism, because access to that mechanism would reduce the costs of the shareholders putting forward their own nominee.

But coming back to where we started—Bob Clark and Bruce Wasserstein—Lazard had just been hired by Carl Icahn to solicit proxies for its own slate of directors. This is not through the corporate proxy mechanism; this is

outside the corporate proxy mechanism, just by their own activity and their own proxy. The SEC recently adopted a rule allowing proxy solicitations over the Internet, which was of value to existing companies because it reduced their cost, but it also may be to some advantage for people like Mr. Icahn, who can use the Internet to solicit their proxies.

We've had a rise of power of shareholders with respect to the nomination of directors, even in the U.S.. So is this a good thing, Sarah, that these hedge fund operators are able to now solicit proxies for their own nominees to the board, and thus achieve much more influence over the board of directors than before? From a shareholder rights point of view?

TESLIK: There's certainly valid concern with regard to the rapidly rising role of hedge funds and private equity funds for shareholders because while on the one hand, they seem to lack the social, labor, and other noneconomic goals that some of the previous active investors had, like the public pension funds and the unions—whose day is largely fading—on the other hand, they have a relatively short-term outlook with regard to sucking money out of the company, which would make it very hard if you were a commodity-based company with a long lead-time for exploration to put money into a company that's not going to come out for 20 years. There is no question there is a valid concern about the time frame of some investors. There is always a valid concern about the time frame, looks, opinions, education, and bent of virtually every shareholder.

I think one of the problems with our corporate governance discussions is we look at shareholders individually and point out all their flaws, but what we forget but probably all agree on is that there is no better system. That private ownership of property has been shown over millennia, over every possible cultural structure, to produce more value than its alternatives. People can buy houses, and yet they have no idea about how to maintain their houses. For almost all of the questions that we're addressing today, if you put them in the context of a car wash owned by three owners and come up with what is the right answer with regard to the balance of power between owners and managers, you will have the right answer. You then have a separate question of how you scale up that answer to deal with large, publicly traded companies. That's where the interesting questions are. How

do you translate what works when I own a restaurant to when I'm one of 50,000 owners of General Motors? Those are very tough questions. That's why there is government involvement. That's why we ask all the questions on this list. They're all attributable, as Guido indicated, to size. They're not attributable to the difficulty of the underlying question. Of course owners should exercise control. Who else is going to do it? So I think that while I'm happy to say hedge funds have a timing perspective that bothers me, if you're going to use that as a reason for why we shouldn't have owners have an effective means to oversee their property, then I will have a problem.

SCOTT: Mat, is the rise of hedge funds just a uniquely American matter, or have hedge funds come to Japan?

NAGATO: These days we are seeing barbarians at the gate. In Japan, the right of shareholders is very strong legally, and they can amend the bylaws of a corporation, or they can propose to nominate directors, or they can even propose to replace the directors. So they have the legal right there, but again since we had so many friendly shareholders, *keiretsu*, they previously have been very quiet. Now, for foreign shareholders, their share is now rising, and even among Japanese, we are observing so many Japanese like Mr. Icahn, and hedge funds are coming to Japan also.

So what are the pros and cons? Well, one shareholder of those rights, when they have been a shareholder for six months, they have to represent 1% of the total voting right, or 300 voting rights. So it's very easy for hedge funds to clear this threshold. And one headache is they tend to focus more short-term profit. It is better for corporations to wake up. They have been sleeping for so long without doing anything using their assets. But if hedge funds' intent is to get money by being active only for a short time, then in the short term, that may not be a very good purpose. This is a problem from now on in Japan, too.

SCOTT: Now, Rolf, you had your own tangle with these fellows through your experience with Deutsche Börse. It seems to me what Mat's saying, and this may be true of Germany as well, is that you've laid out this structure for dominant shareholders and given these dominant shareholders more rights. And now what's happening is these hedge funds are

coming along and making use of the rights that were previously enjoyed by these more traditional old-style shareholders. In the U.S., they're innovating their own rights, because they're operating from a system where basically they have fewer rights than they do in Europe. But what's your experience in terms of whether it's a good or bad idea that hedge funds are apparently assuming more power to influence the decisions of corporations?

BREUER: I think they enjoy the advantage of making use of a sort of aberration of corporate life: that the majority of shareholders do not vote. Which is funny, because that is their preeminent right: to go to the general meeting and say what they feel about management and strategy. They don't attend the meeting, they don't vote, and they don't make use of their primary rights altogether. And hedge funds, of course, make use of this aberration and create majorities, which, if you ask each and every shareholder, do not represent the majority. In Germany, the presence of voting shareholders or votes represented by proxy decreases year after year. At Deutsche Bank's general meeting of last year only 25% of the shareholders were represented, which makes it easy to get a majority. And then the vote is taken, and the rest who are silent have to tolerate what has been decided. So that is something we also have to start thinking about. Perhaps we should think about giving premiums to those shareholders who make use of their votes, either in cash or whatever. To give them an incentive. If they appear and vote, they get more than those shareholders who stay at home. Maybe that gets others interested. I'm not talking so much about the individuals, I'm talking about the institutions.

There is another problem. We talk about global markets, but U.S. institutions that own shares in foreign corporations usually do not vote. That is because the way they administer things is so complicated. You have to go through a proxy committee. You have certain thoughts about: "I have to block my shares? Or for how long a period? That is against my flexibility in managing the fund." The result is that big institutions worldwide, specifically U.S. institutions, do not vote in foreign countries. So they contribute to these sort of irregularities in existing majorities, or seemingly existing majorities. And that of course is the point hedge funds make more and more use of.

SCOTT: So it's one thing to have a majority of the outstanding shareholders be in favor of a proposal, and it's another thing to have a majority of the actual voting shareholders be in favor of a proposal. And since the hedge funds exercise their franchise more than other shareholders, then there's the possible detriment to the other shareholders if they're silent. So where do we go from there? Can we say we should have a majority of outstanding shares as a requirement for voting, as opposed to just a majority of the shares that are cast? Is there a need for an antidote? And if there is, what would it be? Any thoughts on that?

ROITER: The SEC now has on the books a requirement that mutual funds alone as institutional investors publicly disclose their proxy votes. I have to say that the way we've done it at Fidelity is to vote all our shares that we can vote, whether it's a foreign or domestic issue. There are, however, impediments that are placed in the path of institutional investors in the U.S. to voting abroad. A reference was made to the share-blocking rules. These are very serious impediments because they force the investor to make a very difficult decision: As an investor, do I want to vote, or do I want to retain the ability on behalf of those for whom I'm managing this fund to sell out of that company if something dire arises between the time I cast the vote and the date of the shareholder meeting? And often, in some jurisdictions, a date beyond the company's annual meeting. There are other obstacles also. Some jurisdictions don't have record dates, and some jurisdictions force you to be there in person. So we would welcome these impediments being addressed systematically and removed, and you may find that that would be helpful to restore some balance in shareholder voting.

SCOTT: Guido?

FERRARINI: Just a reaction on this point that was raised by Mr. Breuer. In fact, in the EU, we are trying to tackle this problem now with a new directive, which is at the stage of proposal. Actually, it is not yet a proposal. There have been two consultations, and Pierre told me that the proposal will soon be issued. In this proposal, we're trying to make voting easier, particularly in cross-voter situations. So there should be no more requirement as to share-blocking at our meetings, and also proxy voting should be free, and electronic voting should be developed. I was recently at a conference in London, and there was a lot of talk about electronic voting.

SCOTT: George, what's your take on the hedge funds? Are they a menace or a salvation? That's one issue. The second issue is, do we need to make it easier for the non-hedge funds to exercise their franchise, and maybe that would be a partial solution for the problem Dr. Breuer has raised?

DALLAS: I think one of the issues is that it's difficult to define what a hedge fund is, because they have different strategies. And I think that to their credit, many are trying to be engaged responsibly. If the strategy of a hedge fund is to try to use its ownership stake to influence governance practices or corporate strategy, that is within its rights as shareholder. I am not sure that hedge funds should be singled out just because they are more active and engaged than many institutional and individual shareholders. Trying to differentiate owners just on the basis of who they are and how they're defined is very problematic. I think it is more a fundamental issue of short-term versus long-term investment perspectives, and hedge funds are not the only investor group with short-term horizons. Where we need to be concerned about hedge funds is the extent to which they're short-sellers trying to create situations they can take advantage of in the market. But other hedge funds are trying to intelligently increase the long-term value of the firm. So I think we need to be careful about overgeneralizing and demonizing hedge funds.

SCOTT: Jay, do you have a view on this?

LORSCH: I very much agree with the notion that we have to be clear about the problem of short-term investors. That, to me, is a fundamental problem of the U.S. capital market. When you talked about the fact that our concentration of ownership in this country is much less than it is in many European countries, what is the average? Last year, the average share of the NYSE was held for six months or less. So we're talking about a market that is very, very fluid. It is a big problem for directors. If you really talk to them about it, they don't know who the shareholders are in most companies, and the shareholders that are there at one meeting may not be the same people there at the next meeting. And mutual funds contribute to this by their tendency to buy and sell rather than participating in corporate governance in some other way. I understand that's their business, and our whole investment strategy in this country has been based on diversified portfolios, and the way you keep diversified portfolios, apparently, is to continue to buy and sell.

I go back to the hedge funds. Are Relational Investors and Ralph Whitworth the same as Carl Icahn? I don't think so. The goals of the two people and the two institutions are quite different. But what I'm really concerned about is how do we create a strong commitment to long-term investment in this country? Without that, we are going to continue to have a lot of the problems we've had. That's what has driven corporate greed to some extent; it's what drives these compensation systems in the way they operate. It's the biggest problem I think we have in our system right now.

SCOTT: I would make two points on the subject. George, you made the point there are hedge funds and there are hedge funds, and what are they? There's also private equity out there, and private equity may not have 25-year horizons on the investment that Hal Scott has when he puts his money with Eric's firm and looks toward his retirement, but they don't have six-month horizons either, because they're investing in a company to take a role in the company and actually improve the management of the company, and then maybe later sell it, and increasingly maybe not to the public market—to the other private equity firms! And so I think there's that problem: that if we try to just put it all on the funds, there may be some hedge funds that have a longer term perspective. So I guess it's the long versus short term as opposed to the label that we put on the fund itself.

LORSCH: I think with private equity funds, if you're putting your money in one of those funds as an institutional investor or as a wealthy person, you know what their time horizons are—they're telling you. So that's very clear, and you know what you're getting into. These hedge funds have a variety of strategies, and to lump them all into one is probably overly simplistic.

SCOTT: But the line between hedge funds and private equity funds isn't all that clear to me, either. It's not in the label; it's the perspective, the business strategy that you're trying to pursue.

The second point is that this model of "the U.S. capital market is diffuse and the European and Japan market is concentrated" may be changing in very significant ways due to the activity of hedge funds and private equity. More and more funds are coming into the marketplace by investors through other vehicles: traditionally mutual funds, now hedge funds, private equity

funds. Their share of private ownership of the public-owned companies in the U.S. is accelerating. And so we may see a change occurring in the U.S. marketplace in terms of the structure of ownership. Maybe not to the extreme of 66% for one shareholder in Asia, but in the other direction than we've been going, as at the same time ownership of companies in Europe and Asia becomes more diffuse. So maybe we'll meet in one place.

I want to now deal with a couple of fundamental international questions here. First, convergence. Are we converging across the world to one style of corporate governance, or do you envision in the future that we're going to have many styles? We started off by my trying to summarize the rules with respect to board independence and auditors, and then you all talked about differences with respect to shareholder rights. There are major differences. But are these differences decreasing? Are we converging to one model? George, what do you see from your overall perspective on this?

DALLAS: Well, I see a bit of a barbell, if you will. On one extreme end of this barbell will be those companies without the need to access major international capital markets or even their own domestic equity markets. Most of these will have concentrated ownership of some shape or form, often reflecting family ownership, financial-industrial group crossholdings or strong bank relationships. Such companies will feel less market pressure to conform to governance standards outside their domestic market. For these companies the private benefits of control outweigh the need to access external capital for growth. Consequently, the role of independent directors and sensitivity to the interests of minority shareholders may be minimal at this end of the barbell.

The other extreme end of the barbell would include those companies that do seek ongoing access to international capital markets, whether it's the credit market or the equity market—including widely held public companies or closely held firms wishing to raise new capital. For these companies, standards of international capital markets relating to board structure, shareholder rights, transparency, and so on will often provide a more stringent discipline than local domestic market regulation. At least at present, the norms of the international capital markets have a strong Anglo-American orientation. I believe that the Anglo-American model will

continue to exert influence over companies globally, but I also believe that the U.K.’s comply and explain approach allows for greater adaptability than the United States’ more prescriptive framework, and is therefore, a more relevant model for purposes of global convergence.

SCOTT: So Mat, from the Japanese perspective?

NAGATO: I think not only Japan, but each nation is going to be more and more influenced by each other. Japan has been influenced a lot by the U.S., but we were influenced a lot by China a thousand years ago. We have to learn many good aspects of good systems or structures. But that does not mean we are going to have only one system in the world. Right now, for corporate governance, we have our own system, which may not be the best one, and we are still in the transitional period of continuing to learn from many nations. But still, that does not mean in 10 years or 20 years we are going to have only one American system. Still, Japanese culture and society’s characteristics must be there to a certain degree.

SCOTT: Jochen, for Germany to converge with us, the first thing you have to do is get rid of your supervisory board. Is that going to happen in the near term?

SANIO: Quite a lot of things are happening in Germany. “Germany, Incorporated” is dissolving itself by its own decision, and so on. So there is change, but change is not the same thing as convergence, and that’s your question. And you said yourself this needs some vision, because we really don’t know at this moment in time. I can only quote a former German Chancellor who said: “Whenever a person appears who says, ‘I have vision,’ send him to the nearest doctor to check his eyesight.” We have one big convergence project; this is the accounting rules. And if you look into this issue or project, you can see how extremely difficult it is, and we are still only halfway through it. I would not be able to tell you how we all globally will come to terms with it. With corporate governance, it’s even more of a cultural thing than accounting, which is already proving quite a problem.

My final words: be cynical. Where are we coming from? We are coming from some terrible corporate scandals, mainly in the U.S. In Europe, we had

Parmalat. The U.S. had a real problem of lack of investor confidence, and this had to be tackled. And we in Europe like you to go first and volunteer, and try out all the approaches. You are the test case. And where do we stand now? We are in the middle of discussing the fact that the pendulum may perhaps have swung a little bit too far, and this will be corrected over time. The approach in Europe has been much softer. The pressure on the European legislator has not been as strong as here.

It depends on what the objective is. Is the objective to restore investor confidence? How much progress have we made on this? How can you measure it? I don't have an answer. It's the same in Germany. We had this terrible Neuer Market, or New Market, this dot.com bubble that burst, and many people lost their fortunes. To be cynical again, they will never have to answer the question: "Do I have confidence?" again, because they don't have any money any more. We have the numbers. The number of investors has shrunk by more than 1.5 million since the year 2000. It is slowly on the rise. So is one objective to make it rise further? Maybe yes. How much does the new legislation on corporate governance account for this? Or maybe the fact that the stock market in Germany has taken off again is the real reason that people are joining in. And so, in the end, I'm an agnostic, and I'm rather skeptical as regards the word "convergence." Convergence might be a nice dream.

SCOTT: We do have, to some extent, a marketplace, like our federal system internationally, which can vote on this, because companies can choose to list in various marketplaces. Elaine, one of the major sources of new listings is China. And I've noticed that we don't see, post-China Life, a lot of companies listing in the U.S.. Is that a vote of no confidence in U.S. corporate governance rules?

LAROCHE: No. I think it's much more a reflection of the practicalities with respect to how hard they find it to accept some of our prescriptive remedies in the U.S., with respect to large, state-owned enterprises. That said, I don't believe that in China, we are going to see convergence with respect to corporate governance practices or standards. There will be a global principle with a unique and local Chinese application. The challenge here is for all of us to engage them in a dialogue, because there is no cookie-cutter approach.

While the U.S. may have been the beacon of innovation with respect to the policy of regulation, we also have had our missteps. And the real issue on some of the things we're talking about today will have implications for our children when hundreds of billions of Chinese investors will in fact be investing, either on a retail basis or on an institutional basis, in these international companies. And their voices, though now silent, will be heard, and there will be dramatic influence.

One thing I'd like to go back to, regarding an earlier question with the accountants, is that you've got to remember that it's only in the last 10 years that the companies in China, or the state-owned enterprises, or even the newly emerging private companies have come to market. And therefore, what you have is not just issues of auditor concentration, but really a lack of supply. Every person on the 300-member accounting team of my bank I think is probably under the age of 30. So while they may have skill sets, they have no judgment, no world experience, no view. And the international partners who do have U.S.-trained staff have no concept of Chinese accounting, don't speak the language, and do not come to China. So we have a true Wild West when it comes to the marketplace. I can't underscore that enough because we do need to be engaging now on a very broad dialogue. In China, we see vestiges of the European supervisory committee, a little bit from columns A, B, and C, and yet where this will all sort out, quite frankly, I do not know.

SCOTT: Paul, I'm going to give you the last word. I guess the suggestion that George started us off with was that we might be better to move to a more flexible regime in the U.S., use the comply or explain plus disclosure approach, and let the market decide what the best form of corporate governance is rather than mandates. I'd like your view on this from an SEC perspective. Do you see the possibility in the future that we might make adjustments in that direction?

ATKINS: Yes, I think that the market is probably the best mechanism to rely on. We as government entities can't erect barriers to this innovation. We have to apply and formulate proper ground rules to protect against fraud and protect against people who might get caught up in things that they shouldn't be. So I think that's the basic philosophy that we should approach

this with. For all of these issues we have discussed whether we're looking just at the U.S. or across the border, they are very much interconnected. There is one fear that we have from our perspective in Washington that, for example, with the concentration of auditors now, do we have firms that are too big to fail, literally, because we only have four, and everybody is afraid of another Anderson? With respect to shareholder activism in corporations, are we now moving to a different sort of paradigm where "short-termism" is just going to feed on itself because of the dynamics of the marketplace? I mean, all of these things are interconnected, and the good thing is that we are not just an island in the U.S.. We have to rely on what's going on abroad, and we need to be conscious that this is a cooperative venture, and that we can't pretend to have the sole answer here in the U.S. Convergence with respect to accounting rules is just one example. I think it is absolutely vital from an investor protection perspective, as well as a cost issue on companies. That is only one example and you have all sorts of things coming into it: litigation reform, litigation risk, and fear of different cultures. That even if you have the exact same accounting principle stated, it's going to be applied in each culture differently. We're going to have to recognize that, and figure out how we can mutually recognize each other's system. And that's a good paradigm to look at with respect to corporate governance as well.

SCOTT: Thank you.

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