

J O I N T C E N T E R
AEI-BROOKINGS JOINT CENTER FOR REGULATORY STUDIES

UNIVERSITY OF CHICAGO
GEORGE J. STIGLER CENTER FOR THE STUDY OF THE ECONOMY AND THE STATE

*What's Right and What's Wrong with
Corporate Governance in the U.S.
Today?*





The State of U.S. Corporate Governance 2004: What's Right and What's Wrong?

Steven Kaplan
University of Chicago Graduate School of Business

Overview of Talk

- Sense from press that U.S. corporate governance system is terrible / out of control. Is that the case?
 - How has the system performed?
 - How has the system changed over the last twenty years?
 - Why did the scandals occur?
 - What have been the legal and regulatory reactions to the scandals and what effect will they have?
 - What will we see going forward?
-
- Based on work with Bengt Holmstrom of MIT Sloan School

U.S corporate governance system has been demonized.



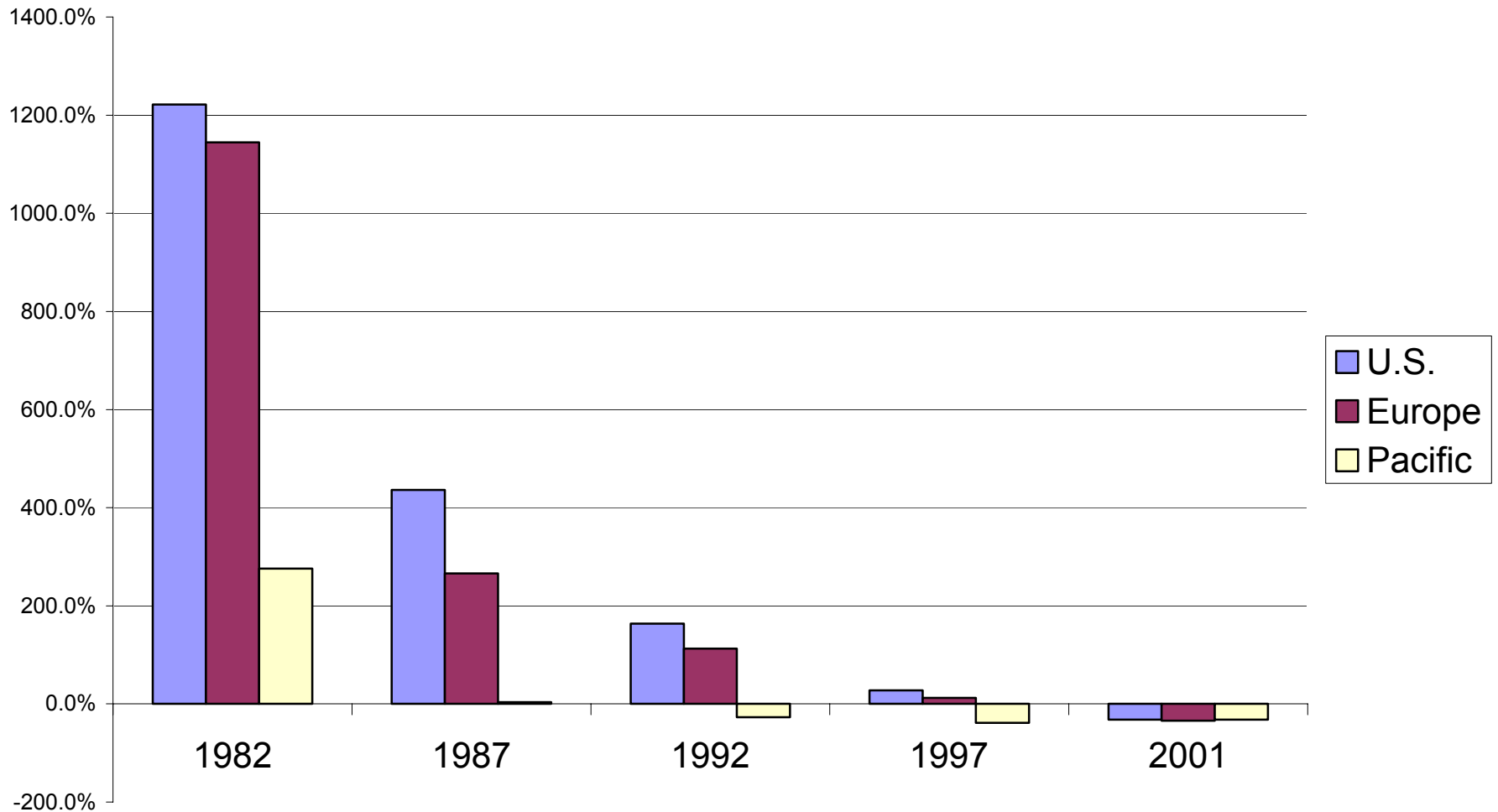
L. Dennis Kozlowski



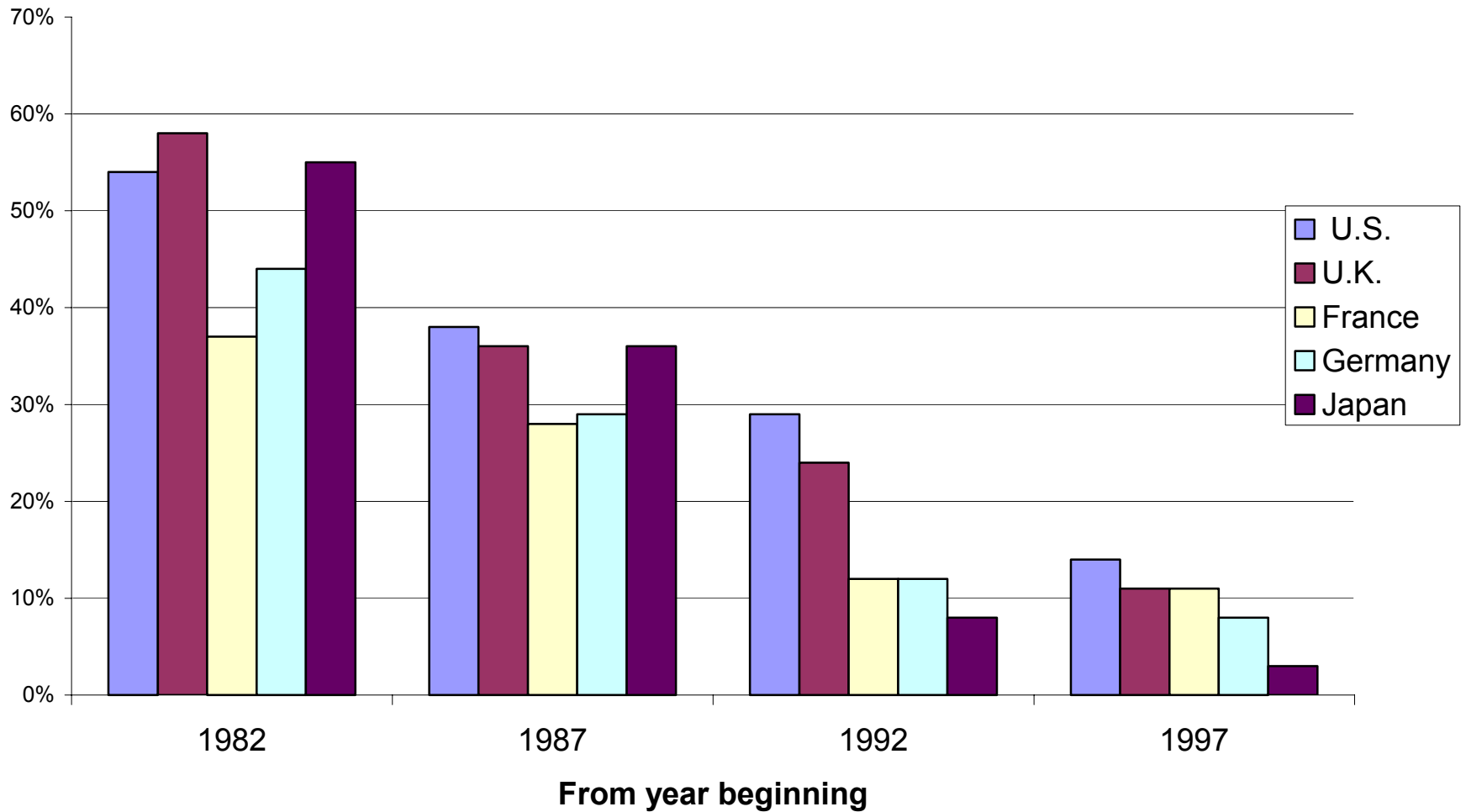
But how badly has it performed?

- If U.S. system is so bad, would expect U.S. to significantly underperform the rest of the world.
 - Has it?

World Stock Market Performance Through December 2002



Growth in GDP per Capita Through 2000



In last year ...

- In 2003, U.S. stock market underperformed others.
 - Driven by dollar depreciation.
 - Overall stock market performance still better than everywhere else since 1987, 1992, 1997.
- From 2001 to 2003, productivity differences have almost certainly increased:
 - I.e., U.S. productivity growth has been spectacular.

U.S. system has performed very well, not poorly. Particularly since early 1990s.

- Glass is not empty. More likely 2/3 full.
 - Not arguing causality.
 - Simply arguing that U.S. has performed well, not badly.



How has U.S. system changed over last 20 years? Why might it have gotten better not worse?

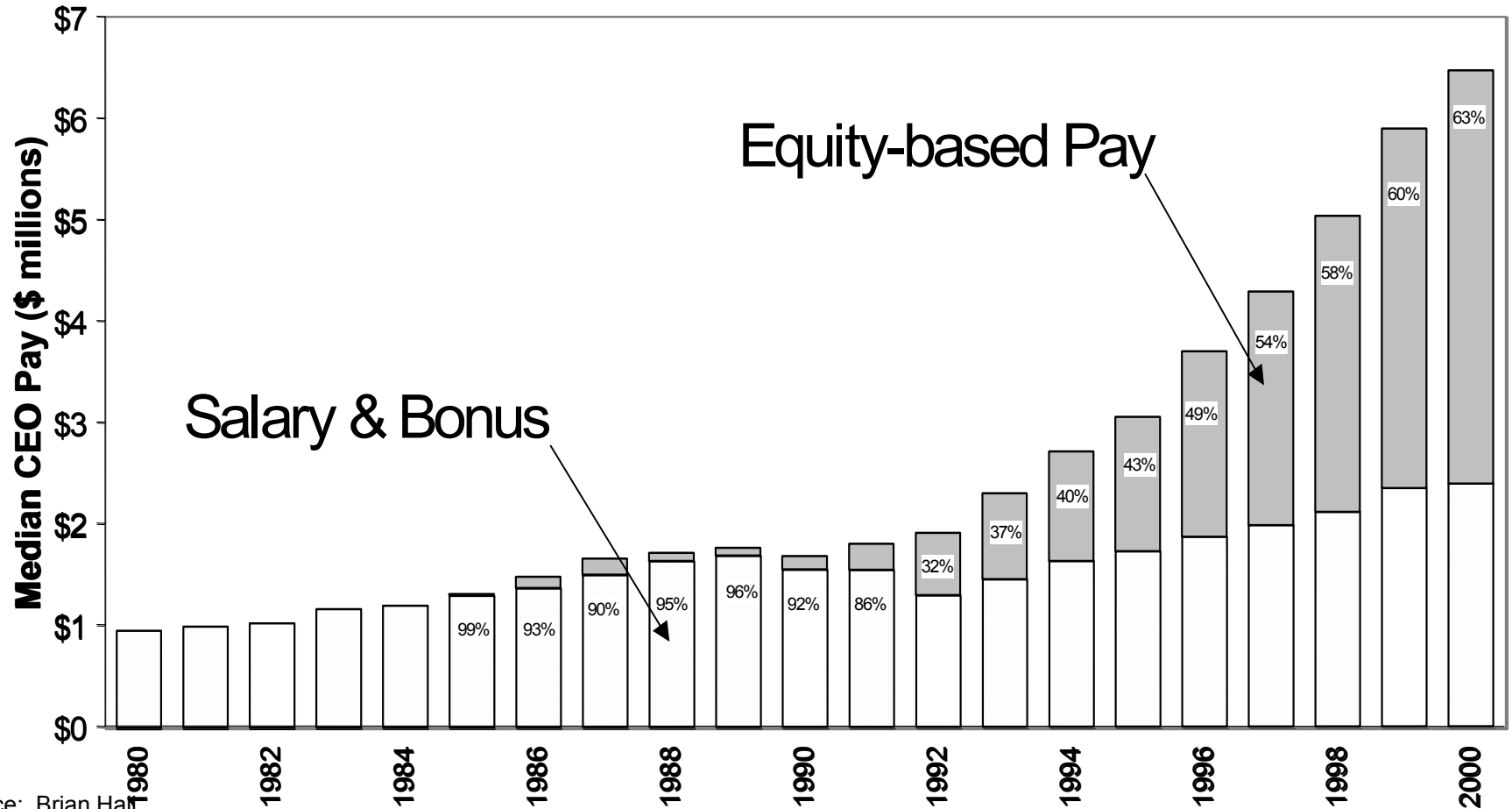
- Three key pieces of corporate governance:
 - Incentives / Compensation.
 - Shareholder activity / monitoring.
 - Boards of directors activity / monitoring.

- The world as of 1980:
 - Before 1980, top executives (and executive compensation) focused on traditional performance measures:
 - » Low stock ownership / options.
 - » Growth-based measures: EPS / Sales growth.
 - Not necessarily tied to shareholder value.
 - Shareholders not the primary focus.
 - Governance / boards not very active.

By 2000, public companies are different

- Changes in executive compensation
 - In early 1980s:
 - » Median compensation of S&P 500 CEO = \$1 million.
 - » Not a lot of equity-based compensation.
 - In fact, median S&P 500 CEO equity-based comp = 0.
 - By early 2000s:
 - » Median compensation of S&P 500 CEO = \$6 million.
 - » Equity-based compensation 63% of total pay.
 - » Increase disproportionately focused on equity-based pay.
 - Overall, CEO pay increases by a factor of 6.
 - Equity sensitivity increases by more than 10 times.

Median pay of top CEOs (in 2001 \$)



Source: Brian Hall

Has increase in pay been good or bad overall?

- Evidence points strongly towards good.
- Why?
 - Primary effect of large shift to equity-based compensation has been to align interests of CEOs and management teams with shareholders' interests to a much greater extent than in the past.
 - Equity-based executive compensation has increased substantially in other countries.
 - Buyout and venture capital investors have made, and continue to make, substantial use of equity-based and option compensation in the firms they invest in.

- Changes in share ownership and monitoring.
 - Stocks increasingly owned by mutual funds and institutional investors who pressure CEOs and management to work for the shareholder.
 - From 30% in 1980 to well over 50% today.
 - Again, this should be a positive development in that there is more accountability.

- Changes in boards of directors. Since 1980, boards have changed in positive ways.
 - Boards have gotten smaller.
 - Boards have become more independent.
 - Boards own more equity.
 - There has been a marked increase in CEO firings.
 - There has been a marked increase in CEOs hired from outside the company.

If the system is so good, what happened?

Good system, but not perfect.

- Executive Compensation.
 - Options and high stock ownership increased the incentive to manage and manipulate accounting numbers.
 - » Boards did not monitor accounting manipulations.
 - » And executives were allowed to sell shares.
 - Options are hard to value and do not show up as an expense on an income statement.
 - » Boards underestimated their value and have given out too many in some cases.
 - Chambers, Eisner, Ellison, Jobs, Siebel.
- Shareholders more active and more influential, but still restricted in actions on which they can vote.
- Boards of Directors have improved, but still plenty of room to improve.

What have legal and regulatory reactions been? What will they do?

- Two big changes.
 - Sarbanes-Oxley Law
 - » Board and auditor monitoring.
 - » Shareholder information.
 - » Executive compensation.
 - New governance rules for listed firms from NYSE and NASDAQ.
 - » Board composition
 - » Board behavior.

- Sarbanes-Oxley (SOX) – effects:

- Positives:

- » Helped restore confidence in U.S. corporate governance system.
 - » Board has greater power and incentives to monitor.
 - Audit committee hires auditor and has greater power.
 - Accountability of management has increased a great deal.
 - Should be harder to manipulate accounting statements.
 - » CEOs and CFOs will have a better understanding of their internal processes and their financial statements.
 - Will lead to better run organizations.
 - Will lead to more accurate financial information and, probably, more conservative accounting decisions.
 - » May lead to positive changes in executive compensation.

- Sarbanes-Oxley (SOX) – effects:
 - Negatives:
 - » Fixed costs.
 - A great deal of busy work and process work created.
 - Greater responsibilities / costs of external auditors and lawyers.
 - » Attention diverted from strategy to busy work / process.
 - Overall:
 - » Probably positive.
 - Particularly in medium and long-term.
 - » Costs relatively higher for well-governed firms.
 - » Costs relatively greater for smaller firms.

- New exchange governance rules -- effects:
 - Board composition – more independence.
 - » Stronger independence requirements.
 - » Stronger conflict of interest definitions.
 - Board behavior – more independence.
 - » Boards must meet without management present.
 - Gives board cover for doing so.
 - Clearly improvements.

Overall effects of scandals: Likely will make good system better.

- Despite scandals, U.S. system is strong / has performed well.
 - Reacted strongly to scandals.
 - System worked.
- Sarbanes-Oxley likely positive on average.
 - Benefits larger for larger companies because of fixed costs.
- Exchange governance changes are clearly improvements.
 - Despite Grasso.
- Non-government reaction also has been positive.
 - No director wants to be on board of next Enron.
 - » Behavior has changed.
 - Insurance companies paying greater attention.
 - Shareholders challenging uneconomic CEO compensation.

What else would I like to see happen?

- Compensation – ensure / increase pay-for-performance.
 - Restrict liquidity.
 - » Do not allow top execs. to sell many shares / options in any particular year. Say 5 or 10%.
 - » Require top execs. to pre-announce any sales.
 - ➔Lowers incentive to play accounting games / manage short-term.
 - Expense options (and all compensation).
 - » Boards, shareholders, management understand costs of compensation.
 - ➔Will reduce uneconomic awards of mega grants.
 - Should be driven by boards and shareholders, not regulation.

Plausibly optimistic future:

- New regulations, more effective compensation, and market incentives lead:
 - boards to monitor more effectively;
 - corporate executives to report more accurately (if not more conservatively);
 - boards to design better compensation contracts;
 - to better governance in general.
- Negative restatements decline markedly in the future, as does the litigation that generally follows such negative restatements.

Why do I say “optimistic” not “certain”?

- Risk of overreaction.
 - Ambiguities in new and existing laws.
 - Will be targets of trial lawyers.
- Risk from other possible sources:
 - Delaware judges becoming more activist.
 - Other judges and juries.
 - More legislation.
 - » Particularly, compensation.
- Risk that directors and executives who act in good faith and take roles seriously can find themselves the subject of criminal prosecution or personally liable.
 - Will adversely effect risk-taking, experimentation, and investment.
 - Will adversely effect who will serve as top executives.
 - Will adversely effect who will serve on boards.

Summary

- Corporate governance should ensure that executives do the right thing (= work for the shareholders).
- U.S. corporate governance system has performed well in last 20 years.
 - Stock performance.
 - Productivity.
 - Executive compensation, boards, shareholders all improved.
- Improvements and changes uncovered weaknesses.
- Legal and regulatory reactions have been positive, albeit not unequivocally.
 - Sarbanes-Oxley.
 - Stock exchange guidelines.
 - SEC.
- At this point, worry more about legal and regulatory over-reaction than under-reaction.