

“Has the Pursuit of ‘Independence’ in Corporate Governance Become Exaggerated?”

American Enterprise Institute

June 12, 2007

Introduction

Alex J. Pollock

“Has the Pursuit of ‘Independence’ in Corporate Governance Become Exaggerated?” is the question for this conference, to which it is my pleasure to welcome you. I am Alex Pollock, a resident fellow at AEI, and we have an excellent panel, whom I will introduce in a moment.

It needs hardly be said that the idea of “independence” has loomed large in the discussions of corporate governance in the Sarbanes-Oxley era, which has now lasted five years. Independent directors have gotten special attention and increased influence; key board committees must now be composed of only independent directors, and some can be considered little fiefdoms inside the board; the SEC’s attempt to require independent chairmen of mutual funds has been litigated; and great efforts are made to insure the independence of public accountants. A new CFTC regulation creates a new class of hyper-independent so-called “public directors.” It is usually taken for granted that more independence is always better—but is that true? In short, we appear to be living with a kind of “independence fetish.”

So it seems an examination of the independence idea is timely, and that is why we are here today. The panel will explore various dimensions of “independence”—in financial institutions, mutual funds, and public vs. private companies—and its possible implications for corporate decision-making.

In my opinion, independence stands in a fundamental trade-off relationship with knowledge. Is independence or knowledge more important to business decisions and successful risk taking? Insiders will always know more than outsiders. A manager working 60 hours a week will always know much more about the business than a director coming to six or eight meetings a year, no matter how assiduously the director may study the board agenda book.

Warren Buffett reflected, “Over a span of 40 years, I have been on 19 public company boards and have interacted with perhaps 250 directors. Most of them were “independent” as defined by today’s rules. But their contribution to shareholder well-being was minimal at best. These people simply did not know enough about the business....”

It has often been pointed out that Enron’s board was a model of independence, at least in structure. Independence without knowledge will not be able to prevent either fraud or honest mistakes.

The most diligent directors cannot match the detailed, specific knowledge of the operations, risks and opportunities of an enterprise, which a competent management must have. If they did, they would be the management, not the board. Should we consider the British model where one-third of the board members are typically executives of the company?

America seems to be headed in the opposite direction. Is a board of all independent directors except the CEO the ideal? Would this control the so-called “imperial CEO”? In one discussion of this question I expressed the view that it would in fact make the CEO stronger. Agreeing with me, a retired CEO of a major industrial company said, “As CEO with everybody else independent directors, I would completely control the board. I would be the only one who really knew anything and all information would flow through me.” That’s a comment worth thinking about.

A different aspect of independence has developed in the accounting firms, where there are examples of accountants not wanting to give advice on the application of complicated and arcane accounting standards for fear of sullyng their independence. This seems to me a reduction to absurdity of the independence idea, creating failure in the central professional responsibility to make judgments and give advice.

My point is not to suggest that independence is not a worthwhile factor, but that it needs to be kept in balance with other factors. How can this be done? I’m sure our panel will provide insights.

You have detailed biographies in your conference material. Let me quickly introduce our panelists in the order in which they will speak.

First, Tom Vartanian, who is a partner of Fried, Frank, Harris, Shriver and Jacobson, where he is chairman of the Financial Institutions Transactions Group and has handled hundreds of financial transactions, regulatory actions, and litigation in the financial services market. He was previously general counsel of the Federal Home Loan Bank Board and with the Office of the Comptroller of the Currency.

Next will be Bill Walton, who has been chairman, president and CEO of Allied Capital Corporation since 1997, having been a director of the company since 1986. Previously he was with Butler Capital Corporation, investment advisor to William Paley, and a senior vice president at Lehman Brothers. He also serves on the boards of the U.S. Chamber of Commerce and the Financial Services Roundtable.

Then we will have Mike Ryan, who is the executive director of the U.S. Chamber of Commerce’s Commission on the Regulation of the U.S. Capital Markets in the 21<sup>st</sup> Century. He was previously executive vice president of the American Stock Exchange, counsel to the National Association of Securities Dealers, and with the Securities and Exchange Commission and Price Waterhouse.

Completing the panel will be my colleague Peter Wallison, who holds the AEI titles of senior fellow, co-director of the financial market deregulation program and Arthur F. Burns Chair in economic policy studies. He was previously a partner of Gibson, Dunn & Crutcher, general counsel of the Treasury Department, general counsel to the Depository Institutions Deregulation Committee, and White House counsel to President Reagan.

Each member of the panel will speak for 12 to 15 minutes, after which we will give them a chance to comment or respond to each other. Then we will open the floor to your questions. We will adjourn promptly at 12:00.