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THE CORPORATION AS A CONTINUING ENTERPRISE

An address by

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This marks the fourth time that I have addressed the Securities Regulation Institute. SRI has become, during my tenure as the Commission's Chairman, the most prominent platform for airing my concerns and views regarding corporate accountability. Twice I have spoken generally of board structure for public corporations. Last year, I addressed issues which arise when a company is involved, as a bidder or as a target, in the takeover process. Today, I will discuss another topic with a pronounced corporate accountability theme -- corporate myopia. I want to share with you some more fundamental concerns I have about how the functioning of our economy, society and markets affects corporate behavior and what I think needs to be done about it. This is a subject I am still working on and this talk might better be described as a "working paper." I continue to challenge my own thinking and would appreciate your challenge and reaction.

The long-term health and dynamics of many American businesses and industries are being jeopardized by an undue emphasis on short-term considerations in their decisionmaking. For more than a decade and a half, instead of formulating policies that enhance the long-term strength of the American industrial system, we have tended to milk it for short-term benefit. We must lengthen our focus if we are to remain a prosperous and competitive nation in the years ahead. My point today will be that for this longer perspective to be achieved the board of directors has a prominent role to play: It has a responsibility for the existence and viability of the enterprise that goes beyond the financial interests of those who happen to hold its shares at a particular moment.

THE AMERICAN CONDITION

At the outset, it is particularly apt to note that this is inaugural week -- and, not merely because it suggests that this will be my validictory SRI address as Chairman of the SEC. The recent election, according to many pundits, was to a substantial degree a vote of dissatisfaction with the condition and management of our Nation's economy. And, in fact, the economic record in the last decade was inferior to all but the terrible 1930s. This has been the most difficult period to run a business in the working lifetime of almost all of us.

Our economic problems are not merely those of poor current performance; but rather of sustained neglect and misjudgment. As a result, our productive infrastructure no longer appears what one would expect of a leading economic power. The United States now has the highest percentage of obsolete plants, the lowest percentage of capital investment, and the lowest growth in productivity and savings of any major industrial society. In fact, over the last two decades, the United States has had the lowest economic investment ratio of any major industrial country.

And, during this period, we have experienced the most severe and sustained peacetime inflation in this century. While some have looked at recent inflation-bloated performance figures and accused business of obscene profiteering, on analysis, we find that -- in many if not most cases -- profits are inadequate. A sampling of inflation-adjusted information -- as now reported in compliance with Financial Accounting Standards Board Statement No. 33 -- indicates that <u>real</u> corporate income in 1979 was on the order of 60 percent of that reported under conventional historic cost procedures. The effective tax, rather than being 39 percent, was on the order of 53 percent. And, dividend payout, which we tend to think of as averaging one-third of earnings, is, in reality, two-thirds. These figures mean that real corporate earnings are, in many instances, inadequate to cover dividend payments and that many companies are paying dividends out of capital. In substance, they are not generating and retaining the resources necessary to maintain their productive capacity and are liquidating, without the awareness of shareholders and often without the awareness even of management or the board. Meantime, two-thirds of inventories, including inventories of many companies which are in such a dire condition, are accounted for on FIFO, which means that those companies are, in essence, paying tax on the effects of inflation on their inventories. I have little doubt that many companies nonetheless continue using FIFO primarily to put a better face on earnings, despite the fact that the marketplace is not misled.

There is, of course, no single diabolical force to which blame for our economic predicament can be laid. We are, instead, reaping the effects of an amalgam of forces which converge to create a powerful -- albeit largely not conscious -- mindset and pressures on our economy and society to emphasize short-term considerations, including:

-- changing life-styles and contemporary values which emphasize instant gratification,

-- the enhanced political leverage and demands of single-interest pressure groups, each focused on getting its "entitlement,"

-- inflation, coupled with growing doubts that we have the will to curb it, which spurs us to "buy now" because it will be more expensive later, and penalizes savings by eroding it,

-- politicians who prefer programs in which the benefits are available immediately, but the costs appear only at a later time when they are classified as "uncontrollable" or "fixed,"

-- an egalitarian focus on wealth transfer and sharing the national product without adequate attention to assuring the future growth of that product.

It should come as no surprise that in these circumstances a national "get it now" mood is so pervasive.

No cause for business' weakened condition, however, has been cited so much as overbearing government. And, that short-sighted government policies are sapping the private sector's vitality and amplifying the myopia of many corporate managers is indisputable. We are, for example, saddled with tax policies which encourage consumption, discourage the savings and investment required to rejuvenate our economic capacities, and communicate the message that the virtue of savings and investment is not valued highly in this society, and its return is not "earned." We are subject to regulations which are often unreasonable and at times counterproductive. And, there is a lack of a consistent and decisive government policy, thus adding the new risk factor of government unpredictability to business decision-making and costs. Restoring an environment in which business can operate more effectively for our mutual betterment is a cause to which I have dedicated much time and energy over the years.

Yet, restoring a balanced government-business relationship, though unquestionably the threshold step, would be, in itself, a far from complete answer to the current American condition. We must also address those forces in the private sector which act to diminish its economic strength and creativity. Indeed, it is too simplistic to attribute all of our economic problems to government or macroeconomic or social conditions; it absolves everyone else of responsibility. A degree of economic regulation is valid and necessary to the health and social order of any organized society. And, it is not necessarily destructive of prosperity. Japan, for example, has environmental laws which many consider far more stringent than those in the United States.

Declaring politically imposed burdens to be the sole culprit for our economic woes also suggests an ease of remedy that is not realistic. Whatever the party in power, whatever the administration, over the last decade and a half our economic problems have accelerated and the momentum of the regulatory process, while possibly no longer accelerating, has not yet been reversed. And, regardless of the philosophical bent of those in office, formal governmental regulatory systems can be dismantled only to the extent that the public's reasonable expectations of private sector performance and conduct could be, with reasonable likelihood, otherwise satisfied. Conversely, if business itself does not provide an environment which fosters public trust and confidence, no political officeholder could insulate it from the consequences. Prominent legacies from the last avowedly probusiness administrations, it should be remembered, include the current ATT anti-trust case, a revitalized Federal Trade Commission and the questionable payments program.

The public's respect and faith in business must be continuously earned; it cannot be merely assumed. Indeed, over the last decade, there has been a subtle shift in the public's attitude towards business that suggests that business' traditionally unassailable reputation for competency has been, to one degree or another, called into doubt. In the 1960s, many will remember, the issues before the business community were whether and how it should apply its vaunted know-how, experience, and ability -- which Servan-Schreiber described in his landmark volume, The American Challenge -- to solving America's most difficult social challenges. We no longer hear this type of talk. The question this Nation now faces is whether business adequately can do its own basic job; whether it can continue to produce the level of goods, services, employment, and real wealth which provide our standard of living and have become the foundations for a free and libertarian society. And, in fact, increasingly common news stories describing heads of prominent firms and industries beseeching government for loan guarantees, protectionist tariffs, and other forms of corporate welfare seem to enhance this concern.

The electorate on November 4 did not, in my judgment, announce a new love affair with business. I believe they expressed a deep dissatisfaction with government and the economy because they were feeling less well off and less secure about their own future and about govenment's ability to deal with the underlying problems.

This condition may, however, translate into an opportunity for business to get a stronger handle on controlling its own destiny. But, no opportunity comes without accountability for how it is seized. To grasp this opportunity, the private sector must be prepared to accept a greater degree of accountability for making the system work than it ever has before.

My sense is that business must address its current economic problems frankly, objectively, and creatively -- in short, with the very intelligence and ingenuity with which it, over the years, has met and overcome so many technical challenges. That means, first of all, accepting responsibility for, and responding to, its own shortcomings and weaknesses. I do not, of course, dispute the right or wisdom of seeking relief from imprudent government policies; such steps correctly should be taken. But, business must also recognize that, in the final analysis, its destiny -- and ultimately ours as a people -- will be fashioned by performance in the economic arena. A private sector which is inefficient and shortsighted would not enjoy the deference, understanding and support of society; while efficient business decisionmaking which is marked by wise judgment and accountability would contribute significantly to public confidence and justify reducing much government regulation.

THE TYRANNY OF THE SHORT-RUN

One important facet of business decisionmaking is its time dimension. In most instances, major business decisions -- such as, introducing product lines, expanding markets, building more efficient production capacity, and developing key personnel -- must be implemented over a period of time. Yet, the behavior of much of corporate management has become increasingly short-term oriented The consequences can be far-reaching. They may deter capital investment, discourage research, and inhibit new product development and other so-called discretionary items which incur immediate expenditures, but may take years to pay off. And, while these may be semi-discretionary on a year-to-year basis, they are not at all discretionary in relation to the long-term health and dynamics of the individual company and the economy as a whole. Akio Morita, Chairman of Sony, stated the problem most succinctly:

> "The problem in the United States is management. Instead of meeting the challenge of a changing world, American business is making small, short-term adjustments by cutting costs, by turning to the government for temporary relief. Success in trade is the result of patience and meticulous preparations with a long period of market preparation before the rewards are available."

How did the perspective of American business become so compressed? And, what can be done to lengthen its focus? Neither the blame nor the remedy is exclusively within government's domain. Numerous commentators point also to management practices as a factor. They cite, as examples, relatively brief tenures for chief executive officers, the mobility of managers who become hired guns for the highest bidder, and incentive packages which unduly accentuate short-run performance in rewarding management. Others claim that unending investor and market pressures place undue emphasis on immediate performance. These commentators note, as illustrations, the demands of shareholders for high current dividends and management's desire to keep stock prices high -- whether to dissuade potential takeovers, to finance their own acquisitions, or simply to make the company look good to the Street.

In a sense, however, these are merely symptoms of a far deeper problem. It is, as I will explain in a few moments, an accountability problem; that is, the corporate system has become structured so that, in many instances, important participants in it may have an interest in milking American business -- or, at least, an insufficient interest not to.

Of course, no system can be subject to such an erosion of its underlying strength for a sustained period without being sapped of its vitality and stability. This situation would be, simply put, unacceptable to American society; our economic and social future would be at risk.

Major corporations no longer can be considered merely private entrepreneurial ventures whose existence or destruction is a matter of public indifference. The modern corporation has become more than the sum of the interests of its shareholders and managers. There is a public interest involved; The corporate sector is the cornerstone of our prosperity and stability, and of the standard of living that undergirds our society and our aspirations. The current federal efforts to keep the Chrysler Corporation viable is an example of the political arena trying to address these societal interests in a troubled corporation.

Now, I turn to the accountability failings which seem to be responsible for this lemming syndrome.

THE MODERN CORPORATION

The Historical Perspective

To better understand the causes for these problems, we should consider the historically-accepted concept of the modern corporation and how it has been affected by -- and made obsolete by -- contemporary economic developments. A half-century ago, two Columbia University professors, Adolf A. Berle, a lawyer, and Gardner C. Means, an economist, analyzed and criticized the accountability structure of the then-contemporary corporation. Real power in the corporate system, they found, lay in those who control the corporation and its directors. And, in retrospect, whatever the inequities of such a corporate system -- and they were many -- this type of corporate model would not force a myopic perspective on those of goodwill. Most importantly, controlling persons in early Twentieth Century corporations tended to have a stable relationship to their company; they acted as would corporate owners. The long-term prospects of the company remained important to them. The Henry Fords, John Rockfellers, and Andrew Carnegies sought to build, not to milk, the enterprises they controlled.

Nor were directors unaware of their mandate. They were, in those days, placed on the boards to represent these controlling interests; they would not countenance managements which placed their immediate welfare over the more catholic interests of those who controlled them. The system, albeit quasi-feudal, provided inherent checks against pressuring the legitimate businessman to overemphasize the short term at the risk of long-term viability.

After the Great Depression and World War II -- in a process that markedly accelerated in more recent years -- corporate ownership and structure underwent fundamental changes. Most importantly, in contemporary times, it has become rare to find a major public corporation controlled, in the absolute sense, by anyone. So diffuse has corporate ownership become, for example, that the Williams Act initially declared a 10 percent interest in a public company significant enough to warrant disclosure under the federal securities laws -- and then that 10 percent figure was reduced to a mere 5 percent threshold.

As a result of such fundamental changes, the American corporation has experienced a restructuring of investor expectations and accountability mechanisms. It is this restructuring which has, in many instances, fostered myopic corporate practices, rewards and incentives, and often left the long-term interests of the corporation without a champion.

<u>Shareholders</u>

The most obvious accountability development of recent times is the changed character of the shareholder and his impact in exacerbating short-term performance pressures. Today, not only is the controlling shareholder nearly an extinct species, but the shareholder who displays the characteristics of ownership --

such as a stable commitment over time to "his" company -- has become increasingly rare.

Indeed, the traditional concept of the investor is becoming obsolete. The linkage between ownership and participation in the equity markets is -- to put it mildly -- strained. Increasingly, the so-called investor is often nothing more than a short-term speculator in the company's income stream.

Presently, something on the order of three-quarters of corporate stock is bought and sold by professional portfolio managers of mutual funds, pension funds, and insurance companies. Although the money they invest may not be needed by their beneficial owners for many years, these managers must do more than invest for the future. They are under pressure to produce the short-term results necessary to keep their jobs and to attract clients.

It is easier to produce immediate results than to explain an investment strategy calculated to produce greater returns over a longer period. In the search for quick profits, they move in and out of large positions based on short-term results, with little regard for the strengths of the underlying enterprise. They tend to be opportunists, rather than long-term investors in the individual business or industries. They are more likely to be attracted by aberrations or short-term performance than by long-term potential for growth.

Moreover, the institutional investment practices of today stress modern portfolio theory and risk diversification. This sort of approach to investing entails little interest in management or in the exercise of shareholders' rights or responsibilities; these investors, for example, typically limit their participation in the corporate electoral process to mechanically voting proxies.

Management

Management's interests also often exaggerate the importance of short-term performance. In fact, whether current management will remain in office may well be determined by its most recent quarterly performance figures. And, the manager who is concerned about insuring this year's bonuses may be less willing to accept several years of lesser earnings in order to introduce a new product line or to break into a new market.

Indeed, a chief executive officer generally expects to be in that office -- to which he arrived only after a lifetime of striving -- for only a relatively brief period of time. Rarely would he anticipate his term to extend beyond five or ten years. Thus, as time progresses, it would not be surprising for him to emphasize those projects which will show positive results during his tenure and to be disinclined to take risks, and possibly even incur diminished compensation, to achieve that for which a successor may receive both credit and financial reward. To the extent that other managers have little corporate loyalty, but rather perceive themselves as mercenaries for sale to the highest bidder, they sell themselves on the basis of a short-term performance record and expect to be gone before the deluge.

The Wall Street Rule

In today's corporate structure, management is not likely to be accountable to the recall of a controlling shareholder -- or, for all practical purposes, even to its body of shareholders, though a corporate electoral process does exist. And, the feeling among many that no direct management accountability to shareholders exists emphasizes a not very satisfactory alternative: The Wall Street Rule. This principle is premised on the notion that a displeased shareholder can, and should, sell-out.

The Wall Street Rule raises some interesting philosophical issues. It seems, for example, a somewhat anomalous principle that the recourse often suggested by management to a shareholder who is dissatisfied with the way his property is being managed is to sell his ownership rights rather than having the practical alternative of firing the manager. Perhaps, this is further evidence that shareholders are no longer thought of as corporate owners.

The Wall Street Rule also has very practical consequences. In essence, it exacerbates the short-term perspectives of both shareholder and manager. When selling their interests is the primary means to express dissatisfaction, shareholders are put into a frame of mind that the only practical way to communicate with management is through the markets. Patience, direct communication, loyalty and constructive criticism are given short shrift in such a system. And, in such circumstances, a shareholder becomes more receptive to the takeover offer. Management, in turn, in anticipation of such an attempt and unsure of the loyalty and support of shareholders, often feels compelled to operate the company with an eye to insuring that stock prices are always sufficiently high to dissuade potential raiders, regardless of the long-term consequences.

The nub of what I am proposing to you today is very disturbing. If correct, it is that the discipline of market price is causing dysfunctional behavior in that the value it places on long-term viability is significantly less than the importance of that viability to the future of our economy and society.

The Board

In short, the corporate accountability mechanism has become misaligned. The present system and its rewards and incentives -- much like our tax policies -- seem to encourage consuming resources and to discourage the investment needed to strengthen our economy. As a result, managers of talent and goodwill are often forced into short-term courses of action which undermine the vitality of the companies they serve.

What we need is a realignment of these dynamics: A key to the long-term economic health of both business and the Nation is an environment in which managers are encouraged to work to the betterment of the corporation as a continuing enterprise. The current environment and set of disciplines does not, in many instances, adequately encourage and reward management to strive for the perspective and judgments that achieve the best balance between short-term generation of profits, cash flow and dividends, on the one hand, and investment in the long-term viability of the enterprise, on the other.

How do we begin to rebalance and establish a more constructive and appropriately supportive environment and disciplines? Before we turn to business itself, and having addressed the need for governmental changes in tax policy toward investment and in reducing regulatory burdens, let us look at other possibilities.

First, the appropriate role for the institutional investor is complex to resolve -- and goes well beyond what I can cover today. I will leave the issue with only two observations:

A. The ownership by many institutions -- banks, pension funds, etc. -- represents enormous and growing power. Even nonexercise is a form of exercise, but perhaps the most benign. We need, however, to consider the consequences very carefully before encouraging them to exercise that power more aggressively.

B. I believe that we should increase the tax burden on short-term trading profits -- including those of tax-exempt institutions -- and decrease it progressively on long-term profits.

Second, I believe that disclosure requirements, demanded by investors who do care, will focus increasingly, in matters such as proxy information, on the kinds of incentives built into executive compensation; that will emphasize the management discussion and analysis and disaggregated financial information addressing the future of the company, such as capital investment, cash flow, liquidity, investment in research and development and new products, trends in market share, etc.

Further, one of the great strengths of our capital market has been its ability to provide equity capital in enormous quantities to finance corporate growth. To the extent, however, that this now causes the corporate community to become slave to the market on a quarter-by-quarter basis, perhaps we need to rethink our views on the debt/equity ratio and encourage more use of debt and less dependence on equity. Alternatively, we might explore ways to divide equity into classes separately tailored to the differing interests of speculators and longer-term interests.

Moreover, to the extent that the threat or fear of takeovers prevents <u>responsible</u> managements and boards from investing adequately in the future, for fear that the impact on current earnings would make them more vulnerable to takeover, our economic system is not well served. We need to consider carefully whether the balance has shifted -- for the time being at least -- from the constructive discipline that the takeover provides against inadequate management to a dysfunctional one. Additionally, there is, I am convinced, a correlation between the complexity of the enterprise as a consequence of a program of acquisitions and conglomeration, and the tendency for senior management to rely on short-term, quantitative, financial control measures -- and less on in-depth "feel" for, and understanding of, the undivided businesses involved.

We also need to encourage and stimulate, as a matter of national policy and priority, the development of new businesses -- including new high technology companies -- to capitalize on the genuis and competitive advantage of this country -- and from which will come much of the new and replacement growth in the economy.

Turning to the established corporation, I view the independent board as an important mechanism in realigning the dynamics. An independent board is more likely to be free from conflicting financial interests in short-term performance -- which would allow it to more dispassionately weigh the time dimension in corporate decisionmaking. And, it has a degree of continuity which allows it to better appreciate, monitor, and adjust a corporation's objectives over time. Thus, for the fourth time in as many presentations to the SRI, my address calls for an enhanced role for an independent board in the corporate accountability process. I would envision two urgent tasks for the independent board: first, neutralizing those dynamics which are inconsistent with the corporation's long-term viability; and second, developing a system for management which recognizes and rewards the desired behavior. The objective: A heightened prospect for long-term viability of the individual enterprise, regaining a leadership position in the world for U.S. business and, most importantly, assuring the future of this Country as a free and libertarian society.

REBALANCING ACCOUNTABILITY

The first task would require, in a sense, the board to reconsider its role and responsibilities in a rebalanced accountability system for the contemporary corporation. We need a system which more accurately reflects the present relation of shareholder to corporation; which acknowledges the predominance of a shareholder who neither wants nor accepts the obligations of ownership. And, we need a model for the contemporary public corporation which recognizes the public interest in an economically vital, self-renewing corporate sector. The fate of our Nation's economic and productive capacity is too important a matter to leave to the whim of an everchanging mix of speculators whose primary shared objective is to make a quick profit and to move on.

We should recognize that the idea of a board whose primary, if not exclusive, mandate is to advance the interests of so-called investors is as archaic as the characterization of a company's shareholders as owners. The proper purpose of a board, rather, should be to direct the corporation as an enterprise whose long-term economic viability has taken on a public importance independent of the parochial interests of those who may momentarily be speculating in its shares. This is not to suggest that long-term economic viability can be viewed totally independently of current considerations and short-term financial interests of its shareholders. But, the overriding factor must be the best interests of the corporation as an economically viable, continuing entity. For example, as I stated in my address on takeovers last year, directors need not necessarily surrender a company's independence merely because a premium price has been offered to its shareholders.

This rebalanced accountability system, which deemphasizes the idea of the shareholder as corporate owner, would nonetheless not abandon the corporate electoral process as it presently exists. Instead, it would accord with the realities and limitations of that process.

In normal circumstances, shareholder voting does not result in anything approaching meaningful elections. Opposition to the incumbents' slate is, at most, nominal. The result is a token contest in which the only suspense relates to whether a paid proxy solicitor can persuade a majority of shareholders to shake off their apathy to sign proxy cards and make the whole exercise legal.

The electoral process, in the contemporary corporation, has meaning only on an exception basis; its most effective use is to register a degree of organized dissent from the company's existing policies. This vehicle should continue to be available to displeased shareholders and efforts should be made to make this system more effective; in recognition that they do have a risk-stake in the company, coupled with the preferability of their using the electoral process, instead of the Wall Street Rule, to further their dissent.

Under this rebalanced system, the board's overriding concern for the corporation as a continuing entity over time -- and the need to create an environment in which management can best address this concern -- would call for its insulating management, as appropriate, from exposure to overbearing, short-term performance pressures. It is well within the board's power to do so. The authority to establish standards for determining whether management will be fired or retained rests with the board. The board should make clear to management that short-term performance standards will not be overstressed in this evaluation process.

Indeed, if a board acting in a company's best interests does not have a sufficient ability to protect and support an executive who is managing the company in its long-term best interests, then both American business and our Nation face a dim future.

Of course, removing the impediments to a longer-term perspective needs to be complemented by performance measures which go well beyond earnings and return an investment. The second urgent task of the board, therefore, should be to establish a basis for assessing performance and for compensating management that furthers the company's interests as a continuing enterprise. And, that would be a system which is also more judicious to management. Certainly, short-term achievements should be measured and rewarded; but only in the context of furthering longer-term corporate objectives. Indeed, because a corporation's success over time depends, to a substantial degree, on continuity and an orderly succession of senior management, I would anticipate that such a board might well tie a current executive's deferred compensation to the performance of his successors -- thus, reflecting on his ability to select and develop his successors and the managerial legacy which he left to them.

CONCLUSION

My remarks today have shared a theme with those of previous SRI sessions: Corporate America is facing a serious, potentially mortal, crisis. The cause can be traced, in significant part, to malfunctions in corporate accountability mechanisms. And, in these circumstances, an effective and independent board of directors has a role to play in creating an environment conducive to a remedy.

I am pleased to note that, increasingly, the challenges confronting business are being faced with the intelligence, creativity and pragmatism which have been the hallmarks of American private enterprise for a century. I remain optimistic for both this Nation and its productive sector. Skeptics who mark these years as the beginning of the demise of American prosperity and economic vitality are wrong. We are, instead, witnessing the self-appraisal and analysis which could provide the necessary foundations to a National renaissance. Achieving National objectives -- much like achieving business objectives -- must be measured according to a long-term perspective.