

# In My Opinion

## Values and Corporate Responsibility: A Personal Perspective by John S. Reed

All is not well in Corporate America. Of greatest concern is the seemingly broad-based breakdown of values and responsibilities highlighted by Enron, WorldCom, Arthur Andersen, the Wall Street “settlement,” and so forth. What happened? Why? What is to be done about it? These are among the urgent questions being posed by an ongoing study of corporate responsibility at the American Academy of Arts and Sciences.

*What happened* seems to be clear. Too many examples of extreme corporate behavior, and the complicating complacency of presumed professionals – directors, auditors, lawyers, and bankers – have severely harmed the trust and confidence essential to free market capitalism.

*Why this happened* is, of course, less clear. Surely incentives were wrong and checks and balances failed to work. The seeds of these problems probably date back to the 1980s, when Corporate America was seen as “stodgy,” a “club” uninterested in financial performance, stockholders or product quality, and a “loser” to new international competition – particularly from Japan. This changed. In remarkable ways, investors became the dominant and aggressive feared force. Cynics would say that the balance and judgment expected of management was “bought off” by large stock-based compensation awards with very short-term payoff and limitless bonus payments. The mantra of stockholder value was enshrined in companies, boardrooms, analyst reports, and the business press. Analysts became all-important and stock price became the measure of performance and self-worth (psychologically and literally!). Too often, integrity and responsibility were crowded out by share-

holder value and the cult of the super-highly paid CEO.

What is to be done? At one level the problem is a straightforward question of values. Companies are expected to be honest and report results as they are. Auditors, lawyers, and bankers are expected to maintain the values derived from their professions. Investment bankers are also expected to be professionals, and analysts to be critical thinkers providing the best possible advice to prospective owners of securities. Regulators and boards are expected to be sources of balance and judgment. Individuals are expected to stand up and be independent of “go along” norms.

The cult of short-term stockholder value has been corrupting. Investors clamoring for performance and share price increases, coupled with unrestrained compensation linked to short-term stock prices, has been demonstrated to be a flawed structure. Similarly, the link between investment banking and retail distribution, without an overarching management structure that is responsible, visible, and accountable, has proven to be flawed. So too has been the role of boards and the functioning of auditors.

So, at a more profound level, what is to be done? I have a few thoughts:

1. Management needs a more wholesome objective than shareholder value. I suggest *evolutionary success*.
2. Boards need to accept and be held accountable for new responsibilities, particularly management values and behaviors, and the impact of incentives.
3. Structural risks must be offset by clear responsibilities and rules. Those who choose to link investment banking, retail analysis, and distribution must be held to a high standard of performance.
4. Auditors and lawyers must be held to be professionals first and foremost. Their expanded activities that raise issues of conflict should be avoided. We can afford to pay the cost of professionalism.
5. The final challenge is to surround the enterprise with a self-evaluating and self-correcting process to ensure continuity across time.

### Management Objective

My own view is that management’s objective should not be “shareholder value,” which, at least in its current manifestation, is too simplistic, but rather *evolutionary success*. Evolution, a dynamic concept, recognizes the reality of continuous change and adaptation. It incorporates the notion of the environment – customers, competitors, regulators



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alike – in defining the determinants of success. It embraces share price (or cost of capital) as a key success factor, but not to the exclusion of others.

A “Report Card” dealing with evolutionary success would be broader and more textured than one limited to shareholder value. It would bring with it more healthy discussion within managements, with the board and with the external community. The concept also embeds a more relevant time frame in all these considerations. If well implemented, it would be hard to distort – a problem that turned out to be fatal to shareholder value. (How many boards have said “Earnings are good, share price is up; all must be well,” only to find that they were wrong?)

### Board Responsibility

One of the most striking features of this history is the failure of boards. Shareholders pressure boards to deliver “results”; yet they fail to appreciate the cost of corrupting the role of these bodies. We must rely on the board to be

the guarantor of values, balance, judgment, and accountability.

We have to look to individual board members, board organization and function, the nature of board discussion, and the board's accountability. Board members must be sophisticated and competent, and cannot be socially or financially beholden to management. Boards must be organized to do their jobs. While it is not vital to distinguish between a Chairperson and a CEO, it is vital to recognize that these are two different functions. If a board is to "do its job," the job must be defined. Boards must:

1. know management's plans and be routinely apprised of progress and problems relating to them;
2. understand and be comfortable with the company's strategy and its key underlying assumptions, and understand the strategies of the company's competitors;
3. understand and be comfortable with the business risks and social expectations for the firm, including control and accounting issues; and

4. know the management and be routinely apprised of development and succession plans.

The board must routinely meet in executive session, as well as alone with the CEO; discuss and criticize its own functioning from time to time; and specifically discuss, and be satisfied with, the values and working environment surrounding the senior team, being particularly mindful of the potential problems stemming from compensation and reward practices. Finally, the board should be able to demonstrate to a reasonable degree that it has understood and fulfilled these responsibilities. Errors will be made, but they should not be errors of omission.

### Structural Risks

Origination and distribution, particularly at the retail level, need not be linked in investment banks. Yet they often are, creating the potential for conflict. Those who choose to operate in this way should be required to certify that the CEO and other senior management have responsibility for maintaining appropriate separations; and that failures to prop-

erly supervise be treated as (a) *personal* and (b) *criminal*, as is currently our practice with price fixing.

### Auditors, Lawyers, and Professionals

Over the last forty years, there has been a gradual but continual movement away from standards and values toward processes and procedures. Where we used to look to accountants to help us properly account for a transaction, we now look to them to verify that it "complies with GAAP." There is a big difference. The same is true with the law, moving from "Is it right?" to "Can it be defended?" What used to be part of an immune system has become too close to being part of operating management. There are many explanations for this change and the relationship cannot be legislated to return to a world that was probably never perfect. However, the value and need for true professionalism must be reaffirmed.

More broadly, Corporate America must reaffirm a commitment to basic values if our system of capitalism is to regain the public's trust. ■

John S. Reed, a Fellow of the Academy since 1998, is the interim chairman of the New York Stock Exchange. This paper, written prior to his joining the NYSE, was prepared for the Academy's study on corporate responsibility and will be included in a forthcoming Occasional Paper: "Beyond Regulation: Corporate Responsibility in America." Mr. Reed currently serves as Treasurer of the American Academy.