Stockholder Rights and Corporate Governance

Stockholders occupy a position of central importance in the corporation because they are the company's legal owners. But the corporation is not always run solely for their benefit, so they contend with management and the board of directors for control of company policies. Recent corporate scandals and debates over executive compensation have challenged companies and government regulators to reform the process of corporate governance to better protect stockholder interests. And individual and institutional investors have demanded greater accountability from those in charge of public corporations.

This chapter focuses on these key learning objectives:

- Identifying different kinds of stockholders and understanding their objectives and legal rights.
- Knowing how corporations are governed and explaining the role of the board of directors in protecting the interests of owners.
- Investigating how recent corporate scandals have affected corporate governance.
- Analyzing the function of executive compensation and debating if top managers are paid too much.
- Knowing how investors organize to promote their economic and social objectives.
- Understanding how the government protects against stock market abuses, such as fraudulent accounting and insider trading.

The board of directors of WorldCom shocked the investment community when it announced in 2002 that the company had overstated its earnings by almost *$4 billion.* Top managers had apparently cooked the books to make the telecommunications giant appear to be making more money than it actually was. When shareholders heard about the fraudulent accounting, they reassessed the value of the firm and began selling WorldCom shares in droves. Within weeks, the once high-flying company had declared bankruptcy, becoming the largest business failure in U.S. history. Stockholders, from small individual investors to big pensions and mutual funds, lost billions of dollars as WorldCom shares became virtually worthless.

The bankruptcy of WorldCom was, without doubt, a disaster for the company's stockholders. What motivated executives at WorldCom to exaggerate the company's earnings? Why didn't the board of directors and the company's accountants exercise greater oversight? Why didn't government regulators do a better job of protecting stockholders' interests? Why didn't stockholders themselves figure out what was going on and sell their shares before it was too late? And what can be done to prevent such a thing from happening again?

Stockholders are the legal owners of corporations. But as the debacle at WorldCom so vividly illustrates, their rights are not always protected. In the mid- to late-2000s, in the wake of this and other high-profile scandals in which stockholders incurred major losses, many groups took steps to improve the overall system of corporate governance. This chapter will address the important legal rights of stockholders and how corporate boards, government regulators, managers, and activist shareholders can protect them. It will also discuss recent changes in corporate practice and government oversight designed to better guard stockholder interests, in both the United States and other nations.

Stockholders

Stockholders (or shareholders, as they also are called) are the legal owners of business corporations. By purchasing shares of a company's stock, they become part owners. For this reason, stockholders have a big stake in how well their company performs. They are considered one of the market stakeholders of the firm, as explained in Chapter 1. The firm's managers must pay close attention to stockholders' needs and assign a high priority to their interests in the company.[1]

Who Are Stockholders?

Two types of stockholders own shares of stock in corporations: individual and institutional.

- *Individual stockholders* are people who directly own shares of stock issued by companies. These shares are usually purchased through a stockbroker and are held in brokerage accounts. For example, a person might buy 100 shares of Intel Corporation for his or her portfolio. Such stockholders are sometimes called "Main Street" investors, because they come from all walks of life.
- *Institutions,* such as pensions, mutual funds, insurance companies, and university endowments, also own stock. For example, mutual funds such as Fidelity Magellan and pensions such as the California Public Employees Retirement System (CalPERS) buy stock on behalf of their investors or members. These institutions are sometimes called "Wall Street" investors. For obvious reasons, institutions usually have more money to invest and buy more shares than individual investors.

Since the 1960s, growth in the numbers of such **institutional investors** has been phenomenal. Studies by the securities industry showed that in 2005, institutions accounted for 67 percent of the value of all equities (stocks) owned in the United States, worth a total of $12.1 *trillion*—nearly three times the value of institutional holdings a decade earlier.[2]

In 2005, one-half of all U.S. households owned stock, either directly or indirectly through holdings in mutual funds, up from one-fifth of households in the early 1980s. "America has become a society of equity investors," concluded a report by the Securities Industry Association. Stockholders are a diverse group. People from practically every occupational group own stock: professionals, managers, clerks, craft workers, farmers, retired persons, and homemakers. Although older people are more likely to own stock, 36 percent of young households (with a decision-maker under age 35) own stock, making up 15 percent of all investing households. Not all shareholders are wealthy; the median household income of owners of stock is $65,000.[3]

Figure 15.1 shows the relative stock holdings of individual and institutional investors from the 1960s through the mid-2000s. It shows the growing influence of the institutional sector of the market over the past four decades.

Objectives of Stock Ownership

Individuals and institutions own corporate stock for a number of reasons. Foremost among them is to make money. People buy stocks because they believe stocks will produce a return greater than they could receive from alternative investments. Stockholders make money when the price of the stock rises (this is called *capital appreciation*) and when they receive their share of the company's earnings (called *dividends*). Most companies pay dividends, but some—particularly new companies with good prospects for rapid growth—do not. In this case, investors buy the stock with the goal of capital appreciation only.

Stock prices rise and fall over time, affected by both the performance of the company and by the overall movement of the stock market. In the mid- to late 1990s, a *bull market* (in which share prices rise overall) produced large gains for many investors; this was followed from 2000 to 2002 by a *bear market* (in which share prices fall overall), in which many investors lost money. Typically, bull and bear markets alternate, driven by the health of the economy, interest rates, world events, and other factors that are often difficult to predict. Although stock prices are sometimes volatile, stocks historically have produced a higher return over the long run than investments in bonds, bank certificates of deposit, or money markets. For this reason, they continue to attract investors, despite the potential for losses.

Although the primary motivation of most stockholders is to make money from their investments, some have other motivations as well. Some investors use stock ownership to achieve social or ethical objectives, a trend that is discussed later in this chapter in the section on social investment. The strategy of acquiring stock in order to take control of a company in a hostile takeover bid is discussed in Chapter 10. Of course, some investors have mixed objectives. They wish to make a reasonable return on their investment but also to advance social or ethical goals.

Stockholders' Legal Rights and Safeguards

As explained in Chapter 1, managers have a duty to all stakeholders, not just to those who own shares in their company. Nevertheless, in the United States and most other countries, stockholders have legal rights that are often more extensive than those of other stakeholders.

To protect their financial stake in the companies whose stocks they hold, stockholders have specific legal rights. Stockholders have the right to share in the profits of the enterprise if directors declare dividends. They have the right to receive annual reports of company earnings and company activities and to inspect the corporate books, provided they have a legitimate business purpose for doing so and that it will not be disruptive of business operations. They have the right to elect members of the board of directors, usually on a "one share equals one vote" basis. They have the right to hold the directors and officers of the corporation responsible for their acts, by lawsuit if they want to go that far. Furthermore, they usually have the right to vote on mergers, some acquisitions, and changes in the charter and bylaws, and to bring other business-related proposals before the stockholders. And finally, they have the right to sell their stock. Figure 15.2 summarizes the major legal rights of stockholders.

Many of these rights are exercised at the annual stockholders' meeting, where directors and managers present an annual report and shareholders have an opportunity to approve or disapprove management's plans. Because most corporations today are large, typically only a small portion of stockholders vote in person. Those not attending are given an opportunity to vote by absentee ballot, called a **proxy.** The use of proxy elections by stockholders to influence corporate policy is discussed later in this chapter.

How are these rights of stockholders best protected? Within a publicly held company, the board of directors bears a major share of the responsibility for making sure that the firm is run with the shareholders' interests in mind. We turn

next, therefore, to a consideration of the role of the board in the system of corporate governance.

Corporate Governance

The term **corporate governance** refers to the process by which a company is controlled, or governed. Just as nations have governments that respond to the needs of citizens and that establish policy, so do corporations have systems of internal governance that determine overall strategic direction and balance sometimes divergent interests. Recent corporate scandals, such as the WorldCom example at the beginning of this chapter, have focused renewed attention on corporate governance, because at times the control systems in place have not effectively protected stockholders and others with a stake in the company's performance.

The Board of Directors

The **board of directors** plays a central role in corporate governance. The board of directors is an elected group of individuals who have a legal duty to establish corporate objectives, develop broad policies, and select top-level personnel to carry out these objectives and policies. The board also reviews management's performance to be sure the company is well run and stockholders' interests are protected.[4]

Corporate boards vary in size, composition, and structure to best serve the interests of the corporation and the shareholders. A number of patterns do exist, however. According to a survey of governance practices in leading firms in the Americas, Europe, and Asia Pacific, corporate boards average 11 members. The largest boards are in banking, insurance, aerospace, and pharmaceutical companies, and the smallest are in small and midsized firms and in the high-tech, retailing, energy, and health care industries. Of these members, usually about three-fourths are *outside* directors (not managers of the company, who are known as *inside* directors when they serve on the board). (In the United States, the New York Stock Exchange now requires listed companies to have boards with a majority of outsiders.) Board members may include chief executives of other companies, major shareholders, bankers, former government officials, academics, representatives of the community, or retired executives from other firms. Eighty-four percent all companies have at least one woman on the board, and 76 percent have at least one member of an ethnic minority.[5]

Corporate directors are typically well paid. Compensation for board members is a complex mix of retainer fees, meeting fees, grants of stock and stock options, pensions, and various perks. In 2005, median compensation for directors at the largest U.S. corporations was $182,304, an increase of almost 60 percent since 2000. (Of this compensation, 40 percent was paid in cash and 60 percent in stock or stock options.)[6] Some critics believe that board compensation is excessive and that high pay contributes to complacency by some directors who do not want to jeopardize their positions by challenging the policies of management.

Most corporate boards perform their work through committees as well as in general sessions. The compensation committee (present in 100 percent of corporate boards), normally staffed by outside directors, administers and approves salaries and other benefits of high-level managers in the company. The nominating committee (97 percent) is charged with finding and recommending candidates for officers and directors, especially those to be elected at the annual stockholders' meeting. The executive committee (46 percent) works closely with top managers on important business matters. A significant minority of corporations (17 percent) now have a special committee devoted to issues of corporate responsibility.[7]

One of the most important committees of the board is the audit committee. Present in virtually all boards, the audit committee is required by U.S. law to be composed entirely of outside directors and to be "financially literate." It reviews the company's financial reports, recommends the appointment of outside auditors (accountants), and oversees the integrity of internal financial controls.

> At Enron Corporation, further described in a case at the end of this book, lax oversight by the six-person audit committee was a major contributor to the collapse of the firm. In the five years leading up to the company's bankruptcy, Enron executives carried out a series of complex financial transactions designed to remove debt from the balance sheet and artificially inflate revenue. These transactions were later found to be illegal, and Enron was forced to drastically restate its earnings. A subsequent investigation found that although the audit committee had reviewed these transactions, "these reviews appear to have been too brief, too limited in scope, and too superficial to serve their intended function." In short, the audit committee, which typically met with the company's outside accountants for only an hour or two before regular board meetings, had simply missed one of the biggest accounting frauds in U.S. history.

Directors who fail to detect and stop accounting fraud, as in this example, may be liable for damages. At WorldCom, for instance, board members agreed to pay $18 million of their own money to settle a class-action lawsuit brought by shareholders. This was later overturned on a technicality, but these directors remained liable in other cases moving forward.[8] Because of tighter regulations and increased risk, audit committees now meet more frequently than they used to, on average 9 times a year.

How are directors selected? Board members are elected by shareholders at the annual meeting, where absent owners may vote by proxy, as explained earlier. Thus, the system is formally democratic. However, as a practical matter, shareholders often have little choice in the matter. Typically, the nominating committee, working with the CEO and chairman, develops a list of possible candidates. These are presented to the board for consideration. When a final selection is made, the names of these individuals are placed on the proxy ballot. Shareholders may vote to approve or disapprove the nominees, but because alternative candidates are often not presented, the vote has little significance. Moreover, many institutional investors routinely turn their proxies over to management. The selection process therefore tends to produce a kind of self-perpetuating system. An exception to this usual process of director selection that occurred at Disney is described in the discussion case at the end of this chapter.

Principles of Good Governance

In the wake of the recent corporate scandals, many sought to define the core principles of good corporate governance. What kinds of boards were most effective? What governance mechanisms offered the best protection against the kinds of abuses that occurred at WorldCom and Enron? During the 2000s, public agencies, investor groups, and stock exchanges all struggled to determine what reforms might be necessary. By the mid-2000s, a broad consensus had emerged about some key features of effective boards. These included the following:

- *Select outside directors to fill most positions.* Normally, no more than two or three members of the board should be current managers. Moreover, the outside members should be truly independent, that is, should have no connection to the corporation other than serving as a director. This would exclude, for example, directors who themselves performed consulting services for the company on

whose board they served or who were officers of other firms that had a business relationship with it. The audit, compensation, and nominating committees should be composed *solely* of outsiders. By 2005, virtually all major companies were following these practices.

- *Hold open elections for members of the board.* Some groups favored a proposal under which dissident shareholders, under certain conditions, could put their own candidates for the board on the proxy ballot. Another idea was for companies simply to nominate more than one individual for each open position, giving owner-voters a genuine choice. Some thought that directors should stand for election every year; others thought that staggered terms were a better idea (for example, on a nine-person board, three individuals would stand for election each year for a three-year term). In any event, the idea was to give shareholders more control over the selection of directors.
- *Appoint an independent lead director (chairman of the board) and hold regular meetings without the CEO present.* Many experts in corporate governance also believed that boards should separate the duties of the chief executive and the board chairman, rather than combining the two in one person as done in many corporations. The independent chairman would then hold meetings without management present, improving the board's chances of receiving completely candid reports about a company's affairs. In 2005, 41 percent of large U.S. company boards separated the roles of chairman and CEO.[9] This practice was more common in the United Kingdom, where it was used in almost all companies.[10]
- *Align director compensation with corporate performance.* Like top executives, directors should be paid based, at least in part, on how well the company does. For example, Coca-Cola announced in 2006 that it would change the way its directors were compensated. Members of the board would be paid only if the company met its earnings-per-share target of at least 8 percent annual compound growth over a three-year period. If the company did not, directors would get nothing.[11]
- *Evaluate the board's own performance on a regular basis.* Directors themselves should be assessed on how competent they were and how diligently they performed their duties. Normally, this would be the responsibility of the governance committee of the board. In the wake of the corporate scandals of the early 2000s, many companies made dramatic improvements in this area; between 2002 and 2004, the proportion of global companies that formally evaluated their board members rose from 35 to 90 percent, according to a survey by surveyed by Governance Metrics International.[12]

As calls for reform mounted, many companies voluntarily took steps to improve their own governance. For example, General Electric (GE) announced a series of changes. It appointed a presiding director, who would lead three meetings of the board annually without management present. The company also set a goal of having at least two-thirds of the board composed of outsiders, and several directors said they would leave to make room for others without ties to GE. "Corporate leadership has lost the benefit of the doubt," said CEO Jeffrey Immelt, in explaining these changes.[13]

The movement to improve corporate governance has been active in other nations and regions, as well as the United States. The Organization for Economic Cooperation and Development (OECD), representing 30 nations, issued a revised set of principles of corporate governance in 2004 to serve as a benchmark for companies and policy makers worldwide.[14] For its part, the European Union has worked hard to modernize corporate governance practices and harmonize them

across its member states. For example, in 2006 the EU proposed new rules to make it easier for shareholders to get information and to vote their proxies. Practices varied greatly across the continent, and only two-thirds of big European companies had "one share–one vote" rules in place.[15] In South Korea, companies in the securities industry launched the Corporate Governance Service in 2002 to promote management transparency and create shareholder value, and began giving awards to companies that achieved the highest standards in corporate governance. In South Africa, the stock exchange announced new rules in 2003 that would require companies to disclose all compensation to directors and what ties, if any, they had to the company. In short, by the mid-2000s the movement to make boards more responsive to shareholders was an international one.[16]

Executive Compensation: A Special Issue

Setting **executive compensation** is one of the most important functions of the board of directors. The emergence of the modern, publicly held corporation in the late 1800s effectively separated ownership and control. That is, owners of the firm no longer managed it on a day-to-day basis; this task fell to hired professionals. This development gave rise to what theorists call the *agency problem.* If managers are merely hired agents, what will guarantee that they act in the interests of shareholders rather than simply helping themselves? The problem is a serious one, because shareholders are often geographically dispersed, and government rules make it difficult for them to contact each other and to organize on behalf of their collective interests. Boards meet just four or five times a year. Who, then, is watching the managers?

An important mechanism for aligning the interests of the corporation and its stockholders with those of its top managers is executive compensation. But recent events suggest the system is not always doing its job.

> In the early 2000s, a number of top executives made out handsomely, even as their companies were wracked by scandal. At Global Crossing, a builder of fiber-optic networks, top managers received millions of dollars in compensation as the company skidded toward bankruptcy. At Enron, CEO Kenneth Lay sold millions of dollars worth of stock in the months before the company collapsed. A study by the Institute for Policy Studies came to the startling conclusion that CEOs at companies under investigation for accounting fraud made 70 percent *more* than average. Why should these executives have been rewarded, when other stakeholders were so badly injured?[17]

Many critics feel that executive pay has become excessive, not just at companies accused of fraud but in fact at most companies, reflecting aggressive self-dealing by managers without regard for the interests of others.

Executive compensation in the United States, by international standards, is very high. In 2005, the chief executives of the largest corporations in the United States earned, on average, $8.4 million, including salaries, bonuses, and the present value of retirement benefits, incentive plans, and **stock options,** according to *BusinessWeek* magazine. (Stock options and the controversy surrounding this form of compensation are further explained in Exhibit 15.A.) This amount represented a 10 percent increase from the prior year, but was still below the peak median pay of $13 million in 2000, at the height of the stock market boom of the late 1990s.[18]

By contrast, top managers in other countries earned much less. Although the pay of top executives elsewhere was catching up, it was still generally well below what comparable managers in the United States earned. To cite just a few examples, the

compensation of CEOs in the United Kingdom was just 55 percent of that of their U.S. counterparts, according to a 2006 study.[19] In France, it was 27 percent; in Japan, 26 percent; and in South Africa, 20 percent.[20] Executives in very similar companies had disparate incomes: Lord John Browne, chief executive of the British firm BP, earned $19 million the same year that David J. O'Reilly, chief executive of the smaller U.S. firm Chevron, earned $37 million.[21] These disparities caused friction in some international mergers. For instance, shareholders at GlaxoSmithKline, a pharmaceutical company formed through a merger of British and American firms, complained loudly when the board proposed a $28 million benefits package for CEO Jean-Pierre Garnier. Garnier, who was born in France but had moved to the United States to head the merged company, said he needed more pay to "stay motivated." But this level of compensation seemed out of line to many European shareholders, and it was later reduced.[22]

Another way to look at executive compensation is to compare the pay of top managers with that of average employees. In the United States, CEOs in 2005 made 411 times what the average worker did. Figure 15.3 shows that the ratio of average executive to average worker pay has increased markedly over the past decade and a half, with the exception of periods of stock market downturn such as the early 2000s.

Why are American executives paid so much? Corporate politics play an important role. In a recent book, *Pay without Performance: The Unfulfilled Promise of Executive Compensation,* Lucian A. Bebchuk and Jesse M. Fried argue that one reason salaries are so high is that top managers have so much influence over the pay-setting process. Compensation committees are made up of individuals who are selected for board membership by the CEO, and they are often linked by ties of friendship and personal loyalty. Many are CEOs themselves and sensitive to the indirect impact of their decisions on their own salaries. Moreover, compensation committees rely on surveys of similar firms and usually want to pay their own executives above the industry average, over time ratcheting up pay for all.[23]

Some observers say that the comparatively high compensation of top U.S. executives is justified. In this view, well-paid managers are simply being rewarded for outstanding performance. For example, Lee Raymond, who retired in 2005, earned $686 million during his 13 years at the helm of ExxonMobil. During this period, the company's market value quadrupled, and the company paid out $67 billion in dividends.[24] To at least some shareholders, his eye-popping pay was clearly worth it. A major share of the increase in executive compensation in the late 1990s resulted from the exercise of stock options, reflecting the bull market of that era, a development that benefited shareholders as well as executives.

Supporters also argue that high salaries provide an incentive for innovation and risk-taking. In an era of intense global competition, restructuring, and downsizing, the job of CEO of large U.S. corporations has never been more challenging, and the tenure in the top job has become shorter. Another argument for high compensation is a shortage of labor. In this view, not many individuals are capable of running today's large, complex organizations, so the few that have the necessary skills and experience can command a premium. Today's high salaries are necessary for companies to attract or retain top talent. Why shouldn't the most successful business executives make as much as top athletes and entertainers?

On the other hand, critics argue that inflated executive pay hurts the ability of U.S. firms to compete with foreign rivals. High executive compensation diverts financial resources that could be used to invest in the business, increase stockholder dividends, or pay average workers more. Multimillion-dollar salaries cause resentment and sap the commitment—and sometimes lead to the exodus of—hard-working lower and mid-level employees who feel they are not receiving their

fair share. As for the performance issue, critics suggest that as many extravagantly compensated executives preside over failure as they do over success. *BusinessWeek's* annual pay survey routinely turns up scores of executives whose companies perform poorly despite their outsized salaries, such as Oracle CEO Lawrence Ellison, who received $781 million in total compensation over a three-year period in which returns to his company's shareholders were a dismal minus 61 percent.[25]

Some shareholder activists have tried to rein in excessive executive compensation. For example, Fidelity Investments, a mutual fund company that manages $1.2 trillion in assets, as a matter of policy opposes pay packages it considers grossly excessive. In 2005, Fidelity voted its proxies against management compensation proposals about a third of the time.[26]

Executive compensation has also been the subject of government regulations. Under U.S. government rules, companies must clearly disclose what their five top executives are paid and lay out a rationale for their compensation. Since 2006, regulators have also required companies to report the value of various perks, from the personal use of corporate aircraft to free tickets to sporting events, which had previously escaped investor scrutiny.[27] These requirements expand stockholders' rights by making it easier for them to determine a manager's total compensation and whether it is justified by the firm's record. The U.S. government also allows shareholder votes on executive and director compensation, and the government of the United Kingdom *requires* such votes. Although in both cases these votes are not binding, they provide a mechanism for shareholders to voice displeasure over excessive compensation.

For their part, many companies have responded to stakeholder pressure by changing the process by which they set executive pay. Most boards now staff their compensation committees exclusively with outside directors and permit them to hire their own consultants. Many firms have sought to restructure compensation to tie top executives' pay more closely to performance. A few top managers have even taken pay cuts, such as Sharper Image Corp.'s founder and chairman Richard Thalheimer, who voluntarily reduced his compensation pay by 50 percent in 2006. The company, whose stock had fallen badly, had laid off employees and scaled back plans to open new stores.[28] A tiny handful of companies have said that top executives cannot earn more than a certain multiple of others' pay. Whole Foods Market, for example, has a rule that no executive's salary and bonus can be more than 14 times what the average worker makes. "We have a philosophy of shared fate, that we're in this together," said John Mackey, the company's co-founder and CEO.[29]

How to structure executive compensation to best align managers' interests with those of stockholders and other stakeholders will remain a core challenge of corporate governance.

Shareholder Activism

Shareholders do not have to rely exclusively on the board of directors. Many owners, both individual and institutional, have also taken action directly to protect their own interests, as they define them. This section will describe the increased activism of three shareholder groups: large institutions, social investors, and owners seeking redress through the courts.

The Rise of Institutional Investors

As shown earlier, institutional investors—pensions, mutual funds, endowment funds, and the like—have enlarged their stockholdings significantly over the past two decades and have become more assertive in promoting the interests of their members.

One reason institutions have become more active is that it is more difficult for them to sell their holdings if they become dissatisfied with management performance. Large institutions have less flexibility than individual shareholders, because selling a large bloc of stock could seriously depress its price, and therefore the value of the institution's holdings. Accordingly, institutional investors have a strong incentive to hold their shares and organize to change management policy.

In 1985, the Council of Institutional Investors was formed. Since then, the council has grown to more than 140 members and represents institutions and pension funds with investments exceeding $3 trillion. The council developed a Shareholder Bill of Rights and urged its members to view their proxies as assets, voting them on behalf of shareholders rather than automatically with management. The activism of institutional shareholders often improved company performance. One study showed that in the five years before and after a major pension fund became actively involved in the governance of companies whose shares it owned, stock performance improved dramatically, relative to the overall market.[30]

> Institutional owners have also influenced change by seeking out companies that practice good corporate governance. A survey of 200 such investors in the United States, Europe, Asia, and Latin America conducted by McKinsey & Company found that more than 20 percent were prepared to pay a premium for the shares of companies that hired outside directors, were responsive to investor requests for information, evaluated their board members, and followed other established governance practices. "I simply would not buy [shares of] of a company with poor corporate governance," said one bank chief financial officer. Governance issues were particularly important to institutional investors in the emerging markets of Eastern Europe and Africa.[31]

The activism of institutional investors, as this survey suggests, has begun to spread to other countries. In many cases, U.S.-based pension and mutual funds that have acquired large stakes in foreign companies have spearheaded these efforts. By 2005, about one in every eight dollars worth of equities owned by American households and institutions was invested in the stocks of foreign companies.[32] To protect their globalized investments, fund managers have become active in proxy battles in Japan, Britain, Hong Kong, and many other countries. The movement for the rights of shareholders—like the investments they hold—is becoming increasingly globalized.

Social Investment

Another movement of growing importance among activist shareholders is **social investment,** sometimes also called *social responsibility investment*, or the use of stock ownership as a strategy for promoting social objectives. This can be done in two ways: through selecting stocks according to various social criteria and by using the corporate governance process to raise issues of concern.

Stock Screening

Shareholders wishing to choose stocks based on social or environmental criteria often turn to screened funds. A growing number of mutual funds and pension funds use *social screens* to select companies in which to invest, weeding out ones that pollute the environment, discriminate against employees, make dangerous products like tobacco or weapons, or do business in countries with poor human right records. In 2005, according to the Social Investment Forum, $2.3 trillion in the United States was invested in mutual funds or pensions using social responsibility as an investment criterion, accounting for nearly 1 in every 10 investment dollars.

Between 1995 and 2005, socially responsible investment grew 4 percent faster than all assets under professional management.[33]

In recent years, socially responsible investing also has grown rapidly in Europe and beyond. In Europe, $435 billion is now invested using social criteria, according to the European Social Investment Forum.[34] Growth has been particularly rapid in the United Kingdom, where government rules require pension funds to disclose the extent to which they use social, environmental, or ethical criteria in selecting investments. Most evidence shows that socially screened portfolios provide returns that are competitive with the broad market.[35]

Social criteria may also be used when selling stocks. For example, some have at various times called for divestment (sale of stock) from companies that had operations in China, where some products were made by forced labor, and in Nigeria, Burma, and Sudan, where repressive regimes had been accused of human rights abuses.

Social Responsibility Shareholder Resolutions

Another important way in which shareholders have been active is by sponsoring **social responsibility shareholder resolutions,** resolutions on issues of corporate social responsibility placed before stockholders for a vote at the company's annual meeting.

The Securities and Exchange Commission (SEC), a government regulatory agency that is further described later in this chapter, allows stockholders to place resolutions concerning appropriate social issues, such as environmental responsibility or alcohol and tobacco advertising, in proxy statements sent out by companies. The SEC has tried to minimize harassment by requiring a resolution to receive minimum support to be resubmitted—3 percent of votes cast the first time, 6 percent the second time, and 10 percent the third time it is submitted within a five-year period. Resolutions cannot deal with a company's ordinary business, such as employee wages or the content of advertising, since that would constitute unjustified interference with management's decisions.[36]

In 2005, shareholder activists sponsored around 600 resolutions dealing with major social issues. Backers included church groups, individual shareholders, unions, environmental groups, and a growing number of pension funds. Many of these groups were members of a coalition, the Interfaith Center on Corporate Responsibility (ICCR), which coordinated the activities of the social responsibility shareholder movement. Some key issues raised in these resolutions included executive compensation, environmental responsibility, antibias policies, and corporate governance.[37] One resolution, for example, called for the separation of the roles of chief executive and chairman of the board at the aerospace firm Textron. The resolution, which had been placed on the proxy ballot by the United Methodist Church, won majority support.[38] "Shareholder advocates concerned with their portfolio companies' social and environmental performance increasingly are reaching the conclusion that these policies cannot be considered in isolation from … governance policies and structure," said a spokesperson for the Investor Responsibility Research Center, an advocate of social investment.[39]

Social responsibility shareholder resolutions usually do not pass; they garner, on average, about 10 percent of votes.[40] This figure does not capture their full influence, however. In recent years, managers have often acted on an issue before the election so shareholder activists will withdraw their resolutions. During 2005, this happened about a quarter of the time. For example, at Coca-Cola a proxy fight was avoided when management agreed to full disclosure of its political contributions. Thus, shareholder activists can have an influence through the proxy election process even when their resolutions are not approved.

Stockholder Lawsuits

Another way in which stockholders can seek to advance their interests is by suing the company. If owners think that they or their company have been damaged by actions of company officers or directors, they have the right to bring lawsuits in the courts, either on behalf of themselves or on behalf of the company (the latter is called a *derivative* lawsuit). **Shareholder lawsuits** may be initiated to check many abuses, including insider trading, an inadequate price obtained for the company's stock in a buyout (or a good price rejected), or lush executive pension benefits. The outcome can be very expensive for companies, as illustrated by the following example involving accounting fraud.

> In 2006, Nortel Networks, a maker of telecommunications equipment, offered $2.4 billion (about 15 percent of the value of the company) to settle two lawsuits brought by shareholders. The plaintiffs charged that the company had reported sales it had not made, defrauding investors who thought the company was performing better than it was and leading to big stock market losses.[41]

In the 1990s, many companies, especially in high-technology industries, complained that they were targets of frivolous shareholder lawsuits. In 1995, in response to these concerns, Congress passed legislation that made it harder for investors to sue companies for fraud. But some executives believed the legislation had not gone far enough, because many shareholder suits disallowed under federal law could still be filed in state courts, and they called on Congress for a uniform national standard for securities lawsuits. Many investor groups, consumer activists, and trial lawyers opposed such a move. In the mid-2000s, in the wake of several high-profile corporate scandals, any such limitations on shareholders' right to sue seemed unlikely.

In many ways—whether through their collective organization, the selection of stocks, the shareholder resolution process, or the courts—shareholder activists can and do protect their economic and social rights.

Government Protection of Stockholder Interests

The government also plays an important role in protecting stockholder interests. This role has expanded, as legislators have responded to the corporate scandals of the 2000s.

Securities and Exchange Commission

The major government agency protecting stockholders' interests is the **Securities and Exchange Commission (SEC).** Established in 1934 in the wake of the stock market crash and the Great Depression, its mission is to protect stockholders' rights by making sure that stock markets are run fairly and that investment information is fully disclosed. The agency, unlike most in government, generates revenue to pay for its own operations.

Government regulation is needed because stockholders can be damaged by abusive practices. Two areas calling for regulatory attention are protecting stockholders from fraudulent financial accounting and from unfair trading by insiders.

Information Transparency and Disclosure

Giving stockholders more and better company information is one of the best ways to safeguard their

interests, and this is a primary mission of the SEC. The stockholder should be as fully informed as possible in order to make sound investments. By law, stockholders have a right to know about the affairs of the corporations in which they hold ownership shares. Those who attend annual meetings learn about past performance and future goals through speeches made by corporate officers and documents such as the company's annual report. Those who do not attend meetings must depend primarily on annual reports issued by the company and the opinions of independent financial analysts.

In recent years, management has tended to disclose more information than ever before to stockholders and other interested people. Prompted by the SEC, professional accounting groups, and individual investors, companies now disclose a great deal about their financial affairs, with much information readily available on investor relations sections of company Web pages. Stockholders can learn about sales and earnings, assets, capital expenditures and depreciation by line of business, details of foreign operations, and many other financial matters. Corporations also are required to disclose detailed information about directors and top executives and their compensation. In addition, many companies have begun reporting detailed information about social and environmental, as well as financial, performance. These trends toward greater corporate disclosure were discussed in Chapters 4 and 12.

At the same time, information is useful to investors only if it is accurate. Fraudulent financial statements filed by WorldCom, Enron, and Adelphia misled investors and led to billions of dollars of losses in the stock market. The reasons for these accounting scandals were complex. They included lax oversight by audit committees, self-dealing by managers, and shareholders who were not sufficiently vigilant. Another problem was that some accounting firms had begun to make more money from consulting and other services than they did from providing routine financial audits. Often, accounting firms provided both consulting and audit services to the same company, creating a potential conflict of interest. Arguably, some accountants were afraid to blow the whistle on questionable financial transactions, out of fear of losing a valuable consulting client.

In 2002, in response to concerns about the lack of transparency in financial accounting, Congress passed an important new law that greatly expanded the powers of the SEC to regulate information disclosure in the financial markets. The law, called the Sarbanes-Oxley Act (for its congressional sponsors), had strong bipartisan support and was signed into law by President George W. Bush. Its impact promised to be enormous. The accounting firm PricewaterhouseCoopers, echoing a common sentiment, called it "the single most important piece of legislation affecting corporate governance, financial disclosure and the practice of public accounting since the U.S. securities laws of the early 1930s."[42]

The major provisions of the Sarbanes-Oxley Act are summarized in Chapter 5. Exhibit 15.B presents some arguments for and against a controversial part of this law known as Section 404.

Insider Trading

Another area the SEC regulates is stock trading by insiders. **Insider trading** occurs when a person gains access to confidential information about a company's financial condition and then uses that information, before it becomes public

knowledge, to buy or sell the company's stock. Since others do not know what an inside trader knows, the insider has an unfair advantage.

Samuel Waksal, former CEO of the biotechnology firm Imclone Systems, was sentenced to seven years in prison and fined $4 million for insider trading. "You abused your position of trust … and undermined the public's confidence in the integrity of the financial markets," said the judge in handing down his sentence. Two years earlier, Waksal had learned that the Food and Drug Administration was about to reject the company's application to market a promising cancer drug it was developing. The news was sure to hurt the company's stock price. In clear violation of the law, Waksal tipped off several family members and close friends to sell their Imclone stock before the FDA made its announcement. "This sentence was definitely designed to send a message," commented a former SEC prosecutor. "No matter how senior you are in the corporate hierarchy, you are going to be aggressively sentenced if you engage in any kind of securities fraud or insider trading."[43]

Insider trading is illegal under the Securities and Exchange Act of 1934, which outlaws "any manipulative or deceptive device." The courts have generally interpreted this to mean that it is against the law to:

- Misappropriate (steal) nonpublic information and use it to trade a stock.
- Trade a stock based on a tip from someone who had an obligation to keep quiet (for example, a man would be guilty of insider trading if he bought stock after his sister, who was on the board of directors, told him of a pending offer to buy the company).
- Pass information to others with an expectation of direct or indirect gain, even if the individual did not trade the stock for his or her own account.

In an important legal case, *U.S. v. O'Hagen*, the Supreme Court clarified insider trading law. The court ruled that someone who traded on the basis of inside information when he or she *knew* the information was supposed to remain confidential was guilty of misappropriation, whether or not the trader was directly connected to the company whose shares were purchased. Under the new court interpretation, insider trading rules would cover a wide range of people—from lawyers, to secretaries, to printers—who learned of and traded on information they knew was confidential. They would not, however, cover people who came across information by chance, for example, by overhearing a conversation in a bar.[44]

The best-known kind of insider trading occurs when people improperly acquire confidential information about forthcoming mergers of large corporations in order to buy and sell stocks before the mergers are announced to the public. More recently, another kind of insider trading, called front-running, has become more common. Front-runners place buy and sell orders for stock in advance of the moves of big institutional investors, such as mutual funds, based on tips from informants. This form of insider trading is often harder for regulators to detect and prosecute.

One region of the world where insider trading has been especially prevalent is the former communist countries of eastern Europe. The transition there to a market economy was generally not accompanied by adoption of the same kinds of government controls that exist in the United States. The result was, in many instances, stock price manipulation and insider trading. The president of one mutual fund with investments in eastern Europe, speaking of the Czech Republic, complained, "Like most postcommunist countries, there was an ingrained system—never tell the truth and always help your buddies."[45]

Insider trading, whether in new market economies or established ones, is contrary to the logic underlying the stock markets: All stockholders ought to have access to the same information about companies. In the Imclone case described above, the CEO had insider information that ordinary investors did not—information that he used to give his family and friends an unfair advantage over others. If ordinary investors think that insiders can use what they know for personal gain, the system of stock trading could break down from lack of trust. Insider trading laws are important in order for investors to have full confidence in the fundamental fairness of the stock markets.

Stockholders and The Corporation

Stockholders have become an increasingly powerful and vocal stakeholder group in corporations. Boards of directors, under intense scrutiny after the recent wave of corporate scandals, are giving close attention to their duty to protect owners' interests. Reforms in the corporate governance process are under way that will make it easier for them to do so. Owners themselves, especially institutional investors, are pressing directors and management more forcefully to serve stockholder interests. The government, through the Securities and Exchange Commission, has taken important new steps to protect investors and promote fairness and transparency in the financial marketplace.

Clearly, stockholders are a critically important stakeholder group. By providing capital, monitoring corporate performance, assuring the effective operation of stock markets, and bringing new issues to the attention of management, stockholders play a very important role in making the business system work. A major theme of this book is that the relationship between the modern corporation and *all* stakeholders is changing. Corporate leaders have an obligation to manage their companies in ways that attempt to align stockholder interests with those of employees, customers, communities, and others. Balancing these various interests is a prime requirement of modern management. While stockholders are no longer considered the only important stakeholder group, their interests and needs remain central to the successful operation of corporate business.

- Individuals and institutions own shares of corporations primarily to earn dividends and receive capital gains, although some have social objectives as well.
- Shareholders are entitled to vote, receive information, select directors, and attempt to shape corporate policies and action.
- In the modern system of corporate governance, boards of directors are responsible for setting overall objectives, selecting and supervising top management, and assuring the integrity of financial accounting.
- The job of corporate boards has become increasingly difficult and challenging, as directors seek to balance the interests of shareholders, managers, and other stakeholders. In the wake of recent corporate scandals, reforms have been proposed to make boards more responsive to shareholders and more independent of management.
- Some observers argue that the compensation of top U.S. executives is justified by performance and that high salaries provide a necessary incentive for innovation and risk-taking in a demanding position. Critics, however, believe that it is too high. In this view, high pay hurts firm competitiveness and undermines employee commitment.
- Shareholders have influenced corporate actions by forming organizations to promote their interests and by filing lawsuits when they feel they have been wronged. They have also organized under the banner of social investment. These efforts have included screening stocks according to social and ethical

criteria and using the voting process to promote shareholder proposals focused on issues of social responsibility.

- Recent enforcement efforts by the Securities and Exchange Corporation have focused on improving the accuracy and transparency of financial information provided to investors. They have also focused on curbing insider trading, which undermines fairness in the marketplace by benefiting those with illicitly acquired information at the expense of those who do not have it.

Discussion Case: *Turmoil in the Magic Kingdom*

In August 2005, Judge William Chandler handed down his decision in a long-running legal case involving corporate governance at the Walt Disney Co. Institutional shareholders had sued the company's directors, saying the board never should have approved a $140 million severance payment to former president Michael Ovitz. The lawsuit demanded that directors personally reimburse the company for this amount plus interest—more than $200 million. In his decision, the judge found that although their decisions had turned out poorly, directors had acted in good faith and were therefore not liable.

Although he ruled against shareholders, the judge did not spare his criticism of Michael Eisner, Disney's CEO. Eisner, the judge opined, had "enthroned himself as the omnipotent and infallible monarch of his personal Magic Kingdom." The judge also spoke harshly of the actions of the board, which he described as "[falling] significantly short of the best practices of ideal corporate governance." He concluded that "many lessons of what not to do can be learned from [the] defendants' conduct here."

Walt Disney Co. was one of the best-known media and entertainment companies in the world, owning theme parks on several continents; television networks ABC, ESPN, and the Disney Channel; and movie studios Touchstone, Miramax, and Walt Disney Pictures. Michael Eisner had taken over the helm at Disney at age 42 in 1984 and had presided over a string of successes, increasing the company's revenue from $1.6 billion the year he took over to $30 billion in 2004, and its market value from $2.1 billion to $48 billion. Along the way, Eisner became one of the highest-paid executives ever, drawing more than $1 billion in total compensation over two decades and winning a spot on *Forbes* magazine's list of wealthiest Americans.

Eisner had hired Ovitz in 1995 to be Disney's president. At the time, Ovitz was considered the most powerful talent agent in Hollywood. Eisner had pushed hard for Ovitz's hiring, winning board approval for his employment agreement after less than an hour of deliberation. But Ovitz's tenure had lasted just 14 tumultuous months, during which Eisner and Disney's new president disagreed repeatedly over key issues facing the firm. Under the terms of Ovitz's compensation agreement, his termination entitled him to a severance package worth $140 million. Ovitz defended this payout, saying it was necessary to compensate him for giving up his lucrative talent agency business.

The trial revealed a governance process in which Eisner, who was chairman as well as CEO, largely controlled the board. The judge wrote: "Eisner stacked his (and I intentionally write 'his' as opposed to 'the company's') board of directors with friends and other acquaintances who, though not necessarily beholden to him in a legal sense, were certainly more willing to . . . support him." Directors who did not toe the line were forced out by Eisner loyalists on the nominating committee.

In late 2003, Roy E. Disney, the nephew of Walt, and his ally Stanley Gold resigned from the board and called on Eisner to step down. In 2004, the two former directors set out on a cross-country trip to organize institutional shareholders to withhold their votes from Eisner in the upcoming director election. They also launched a Web site, *savedisney.com,* featuring a cartoon of Eisner dressed as Snow White, gazing in the mirror and asking, "Who's the greediest of them all?"

The dissident former directors argued that in recent years the company's financial performance had faltered under Eisner's imperious leadership, and they called for greater accountability to shareholders and a clearer link between executive pay and performance. [illegible] holder Services; and the mutual fund companies T. Rowe Price and Fidelity. At a dramatic annual meeting in March 2004, Disney announced that an unprecedented 43 percent of shareholder votes had withheld support from Eisner. That evening, the board stripped Eisner of his chairmanship and gave the position to George Mitchell, a former U.S. Senator.

In the wake of Judge Chandler's decision the following year, Disney took additional steps to reform its corporate governance. Among other actions, the board adopted a new procedure for director elections. If a majority of shareholder votes were withheld from any director, that individual would be required to resign. The board's governance and nominating committee would then have to recommend to the full board whether the resignation should be accepted. "Today's action is the latest in a series of steps we have taken to further strengthen Disney's corporate governance practices," said board chairman Mitchell.

Eisner left the company voluntarily in September 2005.

Sources: James D. Stewart, *Disney War* (New York: Simon & Schuster, 2006); "Ruling Upholds Disney's Payment in Firing of Ovitz," *The New York Times,* August 10, 2005, p. A1; and "Disney Adds a Qualifier for Serving on Its Board," *The New York Times,* August 19, 2005.

1. In your view, did the behavior of top managers and the board of directors at Walt Disney Co. fall short of the standards of good corporate governance described in this chapter, and if so, how? What evidence supports your opinion?
2. Do you believe the compensation received by Michael Eisner and Michael Ovitz was appropriate? Why or why not?
3. What steps did institutional shareholders at Disney take to protect their rights and promote their interests? What additional steps, if any, could or should they have taken?
4. Do you believe that the changes in corporate governance that have been made at Disney are sufficient? Why or why not? If not, what additional changes should be made?

[1] The following discussion refers to publicly held corporations, that is, ones whose shares of stock are owned by the public and traded on the various stock exchanges. U.S. laws permit a number of other ownership forms, including sole proprietorships, partnerships, and mutual companies.

FIGURE 15.1 **-Household versus Institutional Ownership of Stock in the United States, 1965–2005 (Percentage of Market Value, in $ Billions)**

Source: Securities Industry Association, *Securities Industry Fact Book* (New York: Securities Industry Association, 2006). Based on Federal Reserve Flow of Funds Accounts (revised). Household sector includes nonprofit organizations. Used by permission.

[2] "Holdings of U.S. Equities Outstanding," *Fact Book 2005* (New York: Securities Industry Association, 2005). These data are based on analysis of the Federal Reserve Bank's flow of funds accounts.

[3] "Equity Ownership in America, 2005," Investment Company Institute and the Securities Industry Association, 2005.

FIGURE 15.2

Major Legal Rights of Stockholders

[4] For an overview of the role and functions of the board of directors, see Marianne Jennings, *The Board of Directors: 25 Keys to Corporate Governance* (New York: Lebhar-Friedman Books, 2000).

[5] Korn/Ferry International, 32nd Annual Board of Directors Study, 2005.

[6] Pearl Meyer & Partners, *2005 Director Compensation,* available at www.execpay.com.

[7] Korn/Ferry International, 32nd Annual Board of Directors Study, 2005.

[8] "10 Ex-Directors from WorldCom to Pay Millions," *The New York Times,* January 6, 2005, p. A1; and "A WorldCom Settlement Falls Apart," *The New York Times,* February 3, 2005, p. C1.

[9] *Directors' Compensation and Board Practices in 2005* (New York: The Conference Board, 2005), p. 33.

[10] "Emerging Board Practices—A Survey," ICRA Limited, February 2005.

[11] "Coke Directors Agree to Give Up Pay If Company Misses Earnings Goals," *The Wall Street Journal,* April 6, 2006, p. A1.

[12] "GMI Releases New Global Governance Ratings," press release, September 7, 2004, www.gmiratings.com.

[13] "GE to Announce Set of New Policies to Shore Up Board," *The Wall Street Journal,* November 6, 2002, pp. A2, A5.

[14] See www.oecd.org. Information about recent changes in corporate governance practices in Europe is available at the Web site of the European Corporate Governance Institute at www.ecgi.org.

[15] "Corporate Governance in Europe: What Shareholder Democracy?" *The Economist,* March 23, 2005; and "Corporate Governance: Commission Proposals to Make It Easier for Shareholders to Exercise Their Rights within the EU," available at www.europa.eu.int.

[16] The Corporate Library, www.thecorporatelibrary.org, routinely posts news stories from all over the world on current developments in corporate governance reform.

[17] "As Their Companies Crumbled, Some CEOs Got Big Money Payouts," *The Wall Street Journal,* February 26, 2002, pp. B1, B4; and "The (Fat) Wages of Scandal," *BusinessWeek,* September 9, 2002, p. 8.

[18] "Executive Pay: No Hair Shirts, But Still . . ." *BusinessWeek*, May 1, 2006, pp. 36–38.

[19] "How U.K. Shareholders Keep CEO Pay in Check," *The Wall Street Journal* (Europe), April 10, 2006, p. 24.

[20] Towers Perrin, "Worldwide Total Remuneration," in *Worldwide Total Remuneration,* p. 4, at www.towersperrin.com.

An important component of compensation at many companies is stock options. These represent the right (but not obligation) to buy a company's stock at a set price (called the strike price) for a certain period. The option becomes valuable when, and if, the stock price rises above this amount. For example, an executive might receive an option to buy 100,000 shares at $30. The stock is currently selling at $25. If the stock price rises to, say, $35 before the option expires, the executive can exercise the option by buying 100,000 shares at $30, for $3 million, and then turning around and selling them for $3.5 million, pocketing $500,000 in profit, less taxes. Stock options became very popular during the 1990s, particularly in high-tech and other fast-growing companies, because they were seen as a way to align executives' interests with those of shareholders. The idea was that executives would work hard to improve the company's performance, because this would lift the stock and increase the value of their options.

But, in the wake of WorldCom and other corporate scandals, many began to reconsider this form of compensation. The danger was that unscrupulous executives might become so fixated on the value of their options that they would do anything to increase the stock price, even if this involved unethical accounting practices. A 2005 study seemed to confirm this, reporting that the higher the proportion of executive compensation in stock options, the more likely the firm was later to have to restate its profits. Another problem with stock options was that because companies were not required to report them as an expense (even though they cost the company money when exercised), they tended to skew the company's books, misleading investors. And in a bear market, of course, options were less attractive to holders, because they often expired without ever reaching the exercise price.

In 2005, the Securities and Exchange Commission approved new rules that for the first time required companies to deduct the cost of stock options from their earnings. Market observers expected that this change would cut earnings per share in 2006 by about 3 percent, and possibly by much more at high-technology companies that made heavy use of this form of compensation. Some companies responded by phasing out or reducing their use of options.

Sources: "Options Expensing Is Here to Stay," *BusinessWeek,* January 20, 2005, p. 44; "Stock Options: Old Game, New Tricks," *BusinessWeek,* December 19, 2005, p. 34; "Do Options Breed Fraud at the Top?" *International Herald Tribune,* August 5, 2005.

[21] "U.S. Style Pay Packages Are All the Rage in Europe," *The New York Times,* June 16, 2006, p. A1.

[22] "Mad about Money: The Outrage over CEO Pay Isn't Only a U.S. Phenomenon; Just Ask Shareholders in Europe," *The Wall Street Journal,* April 14, 2003, p. R3.

FIGURE 15.3

Ratio of Average CEO Pay to Average Production Worker Pay, 1990–2005

Source: Institute for Policy Studies and United for a Fair Economy, *Executive Excess 2006*, p.30, available online at www.faireconomy.org. Used by permission.

[23] Lucian A. Bebchuk and Jesse M. Fried, *Pay without Performance: The Unfulfilled Promise of Executive Compensation* (Cambridge, MA: Harvard University Press, 2004). Their argument is summarized in "Pay without Performance: Overview of the Issues," *Academy of Management Perspectives,* February 2006, pp. 5-24.

[24] "For Leading Exxon to Its Riches, $144,573 a Day," *The New York Times,* April 15, 2006, p. A1.

[25] "Special Report: Executive Pay," *BusinessWeek*, April 21, 2003, pp. 86-101.

[26] "Do Mutual Funds Back CEO Pay?" *The Wall Street Journal,* March 28, 2006, p. C1.

[27] "How Much Are Executives Really Paid?" *BusinessWeek,* March 20, 2006, p. 96; and "SEC Wants Companies to Tell All on Executive Pay," *The New York Times,* January 21, 2006, p. C2.

[28] "Sharper Image Corp. CEO Will Take a Pay Cut of 50% in Bid to Lower Costs," *The Wall Street Journal,* March 28, 2006, p. 1.

[29] "Putting a Ceiling on Pay," *The Wall Street Journal,* April 12, 2004, p. R11. Whole Food's measure of executive pay does not include the value of stock options.

[30] Council of Institutional Investors, "Does Shareholder Activism Make a Difference?" available at www.cii.org/mono.htm.

[31] McKinsey and Company, "Global Investor Opinion Survey on Corporate Governance," July 2002.

[32] "Share of Total Equities Outstanding," *Securities Industry Factbook 2005,* p. 69.

[33] Social Investment Forum, "2005 Report on Socially Responsible Investing Trends in the United States," available at www.socialinvest.org.

[34] "Socially Responsible Investing Gains Ground Worldwide," *Funds International,* April 2005, p. 10. The Web site of the European Social Investment Forum is at www.eurosif.org.

[35] References to this literature may be found in Donald H. Schepers and S. Prakash Sethi, "Do Socially Responsible Funds Actually Deliver What They Promise?" *Business and Society Review* 108, no. 1 (Spring 2003), pp. 11-32.

[36] Current SEC rules on shareholder proposals may be found at www.sec.gov/rules/final.

[37] Institutional Shareholder Services, "2005 Postseason Report: Corporate Governance at a Crossroads," available at www.issproxy.com.

[38] "Shareholder Resolution on Role Separation Prevails at Textron's Annual Meeting," press release issued by the General Board of Pension and Health Benefits of the United Methodist Church, May 12, 2005.

[39] "2003 Proxy Season Expected to Set Records, with CEO Pay and Global Warming among Top Issues," Social Investment Forum press release, February 12, 2003.

[40] "2005 Report on Socially Responsible Investing Trends in the United States," p 16.

[41] "Nortel Offers $2.4 Billion to Settle Lawsuits," *The New York Times,* February 9, 2006, p. C1.

One of the most controversial parts of the Sarbanes-Oxley Act is known as Section 404. This provision requires public companies to "establish, maintain, and assess their internal control over financial reporting" and to disclose any weaknesses to shareholders. (Private companies are not covered by Sarbanes-Oxley.) The purpose of the rule is to prevent accounting fraud, such as the events that occurred at WorldCom and Enron. Most small companies (with a market capitalization of under $75 million) are exempted from these requirements.

As a practical matter, Section 404 means that businesses must scrupulously document and cross-check all aspects of their financial record keeping. For example, for each accounts payable transaction, one employee has to prepare an invoice and another one has to approve it. Companies must also hire an outside auditor to vouch for the integrity of their internal controls.

Complying with Section 404 has been very expensive. In the rule's first full year in effect, U.S. businesses spent $35 billion on compliance; the average cost for large companies was $15 million and for mid-sized companies $4 million. These figures included management time, fees paid to auditors and attorneys, and the cost of upgraded computer systems. Smaller businesses complained that although they paid less overall than bigger firms, their per-employee costs were higher, hurting their ability to innovate.

Some critics argued that Section 404 had distracted managers from the more important work of running their businesses. "Complying with Sarbanes-Oxley has become a full-time job that forces management to take their eye off the ball," commented Scott Powell of the Hoover Institution. Thomas Donohue, president of the U.S. Chamber of Commerce, complained in a speech to the Securities Industry Association that "the [regulatory] pendulum has swung too far."

Others, however, believed that the price paid was worth it. Many observers thought that once necessary internal control systems had been established, the annual cost of compliance would drop. The presence of Section 404 controls reassured shareholders that financial reports were accurate, strengthening confidence in the stock market. Moreover, new investment in information technology helped companies by providing timelier and better-integrated data. As an

executive of the consulting firm Accenture pointed out, these data could be turned into “a good story that gives [companies] a competitive advantage.”

And some thought the costs of Section 404 had to be measured against the costs of doing nothing. A representative of Ohio’s public pension system, a major institutional investor, commented, “Obviously, to the extent 404 impacts earnings negatively, it’s a concern. On the other hand, who is measuring the cost of corruption and accounting scandals we’ve been through?”

Sources: “Securities and Exchange Commission Roundtable Discussion of Internal Control Reporting Provisions (Section 404 of the Sarbanes-Oxley Act of 2002),” *Gale Group Business Briefing*, May 5, 2005; “Sarbanes-Oxley: The Real Costs,” *Global Finance Magazine*, April 2005, pp. 41 ff; “Are the Benefits of Sarbanes-Oxley Worth the Cost?” *CFO Magazine* 21, no. 7 (May 2005), p. 50; and “A Costly Way to Gain Control,” *The Accountant*, September 2005, p. 4.

[42] PricewaterhouseCoopers, “The Sarbanes-Oxley Act of 2002,” available at www.pwcglobal.com.

[43] “Imclone Founder Gets over Seven Years in Jail, Fine,” *Boston Globe,* June 11, 2003, p. D1.

[44] “Supreme Court Upholds SEC’s Theory of Insider Trading,” *The New York Times*, June 26, 1997, pp. C1, C23.

[45] “A U.S. Fund Manager in Prague Has Found Privatization Corrupt,” *The New York Times*, December 3, 1997, p. D8.

Key Terms

board of directors, *324*
corporate governance, *324*
executive compensation, *328*
insider trading, *337*
institutional investors, *322*
proxy, *323*
Securities and Exchange Commission (SEC), *335*
shareholder lawsuits, *334*
social investing, *333*
social responsibility shareholder resolutions, *333*
stockholders, *321*
stock options, *328*

Internet Resources

www.nyse.com	New York Stock Exchange
www.irrc.org	Investor Responsibility Research Center
www.cii.org	Council of Institutional Investors
www.socialinvest.org	Social Investment Forum
www.socialfunds.com	Site for socially responsible individual investors
www.ecgi.org	European Corporate Governance Institute

Discussion Questions