Washington University Law Review

Volume 81
Issue 2 *After the Sarbanes-Oxley Act: The Future of the Mandatory Disclosure System*

January 2003

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Murray Weidenbaum
*Washington University School of Law*

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Recommended Citation
Murray Weidenbaum, *Choice of Regulatory Regimes and Related Issues of Corporate Governance*, 81 WASH. U. L. Q. 555 (2003).
Available at: https://openscholarship.wustl.edu/law_lawreview/vol81/iss2/10

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# CHOICE OF REGULATORY REGIMES AND RELATED ISSUES OF CORPORATE GOVERNANCE

**MURRAY WEIDENBAUM***

At the outset, let me state my biases. I do not approach issues of corporate governance from the viewpoint of either a lawyer or an accountant. Rather, I have been serving as an outside director—an independent outside director—for a variety of companies, large and small. Invariably, as a green eyeshade economist, I am assigned to the audit committee and, on occasion, to chair the committee.

During this thirty-year period, I have developed some attitudes toward government regulation, including securities regulation. I have to confess that I have not been enamored by the Securities and Exchange Commission (the "SEC") as a bastion of efficient rulemaking. As someone subject to its enforcement activities, I have learned to accept the presence of the SEC and to meet its bureaucratic requirements. Among economists, this restraint of enthusiasm for the SEC is not a minority position. The annual report of the President's Council of Economic Advisers, issued in early February 2003, states the matter quite clearly: "[T]he question of whether SEC-enforced disclosure rules actually improve the quality of information that investors receive remains a subject of debate among researchers almost 70 years after the SEC's creation."[1]

On the positive side, I have been impressed by the variation in the roles of state governments in corporate governance. Specifically, I have become an admirer of Delaware as a state of incorporation. It has not been a race to the bottom, as some describe it. If anything, a race to the top might be more accurate. In any event, Delaware has become the preferred venue for incorporation for several reasons that are related to the present inquiry. Of course, the Delaware justice system is not notoriously anti-business. Rather, the law is up-to-date and the judicial system has earned a reputation for

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* Murray Weidenbaum holds the Mallinckrodt Distinguished University Professorship at Washington University. He has served on a wide variety of corporate and non-profit boards and has written on corporate governance from the viewpoint of the outside director.

1. Economic Report of the President Transmitted to the Congress, U.S. Government Printing Office 95-97 (Feb. 2003), *available at* http://w3.access.gpo.gov/usbudget/fy2004/pdf/2003_erp.pdf (last accessed Aug. 18, 2003).



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efficiency, fairness, and especially for understanding the world of business.

We can cite other examples to show the practicality of choice or competition in corporate governance, such as the alternatives of state and federal chartering of banks.

To muddy the waters a bit, I also note the voluntary progress that has been made. The New York Stock Exchange has led a long series of voluntary improvements in corporate governance. Some of the most important have related to establishing the audit committee and enhancing its independence. The efforts of the Exchange continue to this day.[2]

In the voluntary area, many boards of directors have shifted their composition from a dominance of insiders to a majority of outsiders. This development has occurred in the absence of new law or regulation.

Turning to more recent events, it became clear before the passage of Sarbanes-Oxley that Enron is a presence in boardrooms just as Andersen is a presence in audit committees. Surely no director wants to suffer the disgrace of Enron directors, some of whom have been forced off other boards just because of their Enron connection.

In this light, I saw some special charm in applying the approach of federalism to the subject of disclosure of financial information. It should not be surprising that this economist would viscerally favor a large role for competition. In that environment, investors would place a premium on the shares of firms operating under the regulatory regime that they prefer. Rather than simply relying on my gut feel, I have drawn upon the good work of Roberta Romano of the Yale Law School, especially her recent monograph, THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES REGULATION.[3]

However, Merritt Fox's paper has gotten me to rethink my position. First of all, how can any economist object to his proposition that marginal social benefits should equal marginal social costs? If I even waver, Princeton will revoke my Ph.D. Nevertheless, I find myself raising an uncomfortable question: "In an increasingly global financial marketplace, does it really make sense for the international investor to face a bewildering variety of corporate reporting systems?" I find eminently reasonable Professor Fox's proposal that the proper locus of regulation should be the place where the issuer has its "economic center of gravity," rather than where the securities

2. For details, see Murray Weidenbaum, *Governance Leadership: System Failure, System Renewal*, DIRECTORS & BOARDS, Summer 2002, at 25-31.

3. ROBERTA ROMANO, THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES REGULATION (2002).

are offered or purchased.[4]

But, as a chronic temporizer, let me suggest that perhaps a variation of the federalism approach might be useful. That is, broad principles might be promulgated indicating the types of financial information that should be provided. Under these relatively general guidelines, specific regional variations could be accommodated. Thus, the appropriate organizations in the United States, the European Union ("EU"), Japan, and other major nations would adopt the global guidelines. Within this framework, the individual member nations of the EU might be permitted to choose specific patterns consistent with the guidelines, as would the individual states in this country. This entire subject could benefit from a great deal more research and analysis. Professor Fox has made a fine attempt to move thinking in a positive direction.

Turning to an economic issue, I have an empirical problem with his characterization of the patterns of global economic integration. I would draw on a more dynamic analysis. For example, in the last several decades, the United States has become a much more open economy. The flow of internationally tradable goods and services has been rising substantially faster than national output (i.e., gross domestic product). Also, during the course of manufacturing many products, such as an automobile, an increasing amount of cross-border flows of components occurs. Also, many localities report a painful shift of basic production from domestic locations to more cost-effective Asian sites. Even in the area of services, entrepreneurs are overcoming barriers to international labor mobility by moving selected business functions to workers overseas.

In the EU in contrast, the trend is somewhat different. Before the establishment of the EU, about 40 percent of the foreign trade of the member nations was within what is now the EU. Following the elimination of trade barriers within the EU, closer to 80 percent of the international trade of the member nations is occurring within the confines of the EU—thus much less with other continents. Nevertheless, the typical European economy is still measurably more open than that of the United States. In a sense, of course, we are the original common market.

Jonathan Macey's paper makes a variety of sensible observations about the serious shortcomings of corporate governance in the United States.[5] I

4. Merritt B. Fox, *Optimal Regulatory Areas in Securities Disclosure Regulation*, 81 WASH. U. L.Q. (forthcoming Feb. 2003).

5. Jonathan R. Macey, *A Pox on Both Your Houses: Enron, Sarbanes-Oxley and the Debate Concerning the Relative Efficacy of Mandatory versus Enabling Rules*, 81 WASH. U. L.Q. 329 (2003).

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would like to focus on the valid point he raises about the lack of independence of directors from the management, but offer a more positive response. Of course, it is fortunate that Sarbanes-Oxley avoided dealing with fundamental questions such as the leadership of American corporations. That is a matter for shareholders and boards of directors.

Let me turn to what I believe is the heart of the matter. It has become increasingly evident that the CEO/chairman typically dominates the corporate governance process. In about nine out of ten large companies, the same individual holds both positions. On the surface, that may sound like an efficient way of coordinating board and management activities. Surely, no committee (and that is the organizational form of a board) can run an organization, at least not effectively.

Nevertheless, it is very intimidating for an outside director to serve on the body that provides the oversight of the management when it is led by the most senior member of that management. If I were not in the midst of a distinguished group of attorneys, I might describe the prevailing system as an inherent conflict of interest. Instead, I merely cite the views of John G. Smale, retired CEO of Procter & Gamble and former outside chairman of General Motors. Smale notes that as a CEO/chairman he would not have welcomed a diminution of his authority. He also reports that he saw his outside chairmanship at the time as merely a transitional appointment. However, Smale has changed his mind, as shown in his latest writing on the topic:

> If the purpose of a board is to represent the shareholders in overseeing management's conduct of the business, such a structure [as an outside director serving as chairman] seems considerably more logical than having the board chaired by a manager who is also the subject of such oversight.[6]

This change would go a long way to respond to Professor Macey's serious concern. It would alter the fundamental dynamics of the boardroom. I suggest that the proper time to consider such a shift is when a new CEO is being selected, surely not during the incumbency of someone who presently holds both positions.

A more modest proposal involves a similar recognition of the uncomfortable lack of independence with regard to the internal audit. Typically, this function reports to the chief financial officer or to a subordinate. In my experience, it is desirable to shift the reporting

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6. John G. Smale, *Where Was the Board?* ACROSS THE BOARD, May/June 2002, at 11-12.

relationship to another knowledgeable member of the senior management, such as the chief legal counsel or the chief operating officer. The independence of the internal audit is also enhanced by a good working relationship with the audit committee. This is another way of strengthening the position of the outside directors.

A final thought: there is a broad range in the scope and severity of government regulation of business in the United States. At one extreme, we find controls over entry, exit, price, and profits, as typified by public utility commissions. An intermediate position is held by agencies in the area of safety and the environment. These agencies regulate the ways that companies conduct their activities. At the other end is located regulation with the lightest touch—the requirement for the provision of information. With proper recognition of the costs imposed, this is the mildest form of governmental intervention in business decision-making. There is a useful lesson here from the checkered history of regulation. Success at this mild stage of regulation can obviate the need and surely reduce the pressure for more intrusive forms of government intervention.[7] That underscores the substantive importance of this Symposium, whose endeavor it is to improve the information that business provides to the government and thus to the public.

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7. For elaboration of this point, see Murray Weidenbaum, *Restoring Public Confidence in American Business*, THE WASHINGTON Q., Winter 2002-03, at 53-62.