



What Should Society Want from Corporate Governance?

Alex J. Pollock

For the maximum benefit of society as a whole, “corporate governance” must mean more than trying to reduce the frequency of corporate scandals. The immense cost of the Sarbanes-Oxley Act reflects a typical reaction—or overreaction—to the aftermath of a financial bubble. Although the monetary costs frequently get the most attention because they are immediately apparent, other factors need to be considered. These include what opportunity costs are imposed, whether the burden of increased controls and regulation induces mediocre performance, and broadly, whether society’s corporate governance portfolio should resemble a portfolio of Treasury bills or of equities. What is the trade-off between independence of directors and knowledge and how should these be balanced? These issues need to be considered in any discussion of optimal corporate governance.

How should a free society with a market economy view the purpose of corporate governance structures and practices? Is it only to reduce the incidence of financial fraud and scandal, which a certain number of egregious cases make notorious?

This typically becomes the single-minded focus of corporate reforms in the cycles of financial history in the period after a boom has turned to bust, and this pattern has repeated once again in our own time. It is never an excuse, but what came to light in the wake of the popping of the most recent stock market bubble was hardly new. History is clear that as an empirical matter, booms induce fraud and swindling.

The Historical Pattern

According to Charles Kindleberger in *Manias, Panics, and Crashes*, “The propensities to swindle and be swindled run parallel to the propensity to speculate during a boom.”¹ The 2005 edition of this book, revised by Robert Z. Aliber, observes, “Fraudulent behavior increases in economic booms.

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Fortunes are made in a boom, individuals become greedy for a share in the increase in wealth and swindlers come forward to exploit that greed. The number of sheep waiting to be sheared increases.”²

Writing in 1873, Walter Bagehot put it this way in the classic *Lombard Street*:

The good times of too high price almost always engender much fraud. All people are most credulous when they are most happy; and when much money has just been made, when some people are really making it, when most people think they are making it, there is a happy opportunity for ingenious mendacity.³

Bagehot continues, “Almost everything will be believed for a little while.” Think of *Dow 40,000*, a book published in 1999.

Finally, Cato the Elder (234–149 B.C.), writing during the Roman Republic, explains, “Men’s spirits are lifted when the times are prosperous, rich and happy, so that their pride and arrogance grow. . . . Good fortune, which leads them to rejoice, usually makes them stray from right counsels.”⁴

That is the psychology and the behavior of the boom. Then comes the bust and the psychology

and behavior of the aftermath of the bust, when all changes. In the aftermath, the focus is on punishment and humiliation of the swindlers, especially those who were formerly highly placed, rich, powerful, and lionized. The theme is:

*Many of proud and laurelled brow
Will sink and writhe in shame—*

Not to mention in handcuffs.

In reaction to the scandals, many new controls are imposed. The Sarbanes-Oxley Act is a current legislative example, but its predecessors go back to the Bubble Act of 1720. New regulations, rules, accounting procedures, and reports of blue ribbon committees and commissions try to guarantee that good financial behavior will follow, all with the theme of ensuring that “this will never happen again.” Of course, in the next cycle, it happens again anyway.

At What Cost?

The goals of improved controls and accounting, honest disclosure, and responsible behavior are certainly right and appropriate. The means of trying to achieve them through masses of new rules, bureaucratic overhead, and in general mechanistic requirements, however, may easily run to extremes in reaction to the preceding extremes of the boom time.

The intentions of the new rules are laudable, but they are imposed on *everybody*, not just the guilty. At what cost and what opportunity cost?

The outsized expenses resulting from the requirements of Sarbanes-Oxley and especially its notorious Section 404 are well known and widely discussed. There is no doubt they have been very costly for every company and its shareholders, and disproportionately costly for small public companies and their shareholders, although this result has been an incredible bonanza for the accounting firms.

In an insightful discussion of corporate governance in his 2002 annual report letter, Warren Buffett concludes that although he likes having outside directors meet without the CEO, “I doubt, however, that most of the other new governance rules and recommendations will provide benefits commensurate with the monetary and other costs they impose.”⁵

Will the new Sarbanes-Oxley and other controls prevent fraud and scandal during the next boom when it comes? The testimony of history suggests not.

In the meantime, the costs will be real. How should society weigh their effects on corporate governance?

In particular, what are the opportunity costs? In addition to the monetary expenses, what might corporate governance be giving up in exchange for getting new rules, regulations, forms, and mandates? Is it possible that the post-bust reaction and its psychology have created a systematic loss of opportunity?

This case has been made in a provocative way, as quoted by the co-editors of *Value Investor Insight*:

One of the most thoughtful investors we know is also dubious that the “new world” of board activism is all it’s cracked up to be. “I can think of not one single example where an independent board has been even a contributing factor in building a great company,” he wrote us in a recent e-mail. “A CEO is essentially a capital allocator, like a fund manager. Do you think that a fund manager overseen by a committee whose fundamental motivation is fear of embarrassment is likely to produce good investment returns? Just as I would not want to invest with a fund manager that makes decisions by committee or out of fear of being criticized, I do not think that corporate performance will be improved by more powerful boards. . . . About all I’m sure of is that by eliminating ‘imperial’ CEOs, you are more likely to eliminate those who excel than to inhibit those who are corrupt. The most likely outcome is mediocrity.”⁶

To pose a question to the reader: Can you think of a great company that was built by an independent board, as opposed to a driven entrepreneur or a powerful CEO?

Suppose it is true, as our thoughtful investor argues, that there is a trade-off between heavier controls and corporate performance. Suppose that the reforms intended to reduce fraud also tend to produce a higher proportion of mediocrity through greater risk aversion and consequent failure to seize opportunities. For example, the National Association of Corporate Directors suggests, “Directors will not take value-enhancing risks if they are paralyzed by undue fears of personal liability.”⁷

Suppose that the new rules and controls *do* succeed in reducing the incidence of fraud (to make the case most clear by an impossible ideal) to zero. But suppose also that they simultaneously reduce the incidence of outstanding success, always attained by taking risks, so that the average

corporate performance falls. There is no scandal, but there is less innovation, less risk-taking, and less opportunity. The dispersion around the mean performance is reduced, but the mean performance is lower.

Would this be a good deal for society? It would not.

Having said that, it must be admitted that mediocrity has its adherents. I once heard a senior, lifelong regulatory bureaucrat give a speech in which he described his ideal of banking as a football game played entirely between the two thirty-yard lines. A game with no touchdowns is perhaps an understandable ideal for an employee of a regulatory agency with a personal payoff matrix of all downside and no upside. But no equity investors—not to mention no football fans—share this vision.

Neither should corporate directors, who represent the equity investors. Corporate governance should always be aware of and managing downside risks, including the risks of fraud, but should not be dominated by them.

Corporate Governance as a Portfolio Problem

What society wants from corporate governance in the aggregate is maximum production of economic well-being. This requires innovation, experimentation, and seizing opportunities; it also requires control, probity, and risk management. How much experimentation and innovation is it sensible to give up in exchange for how much reduction in fraud and scandal? How much protection from loss in exchange for how much sacrifice of upside possibilities?

Suppose we think of corporate governance as an investment by society in a portfolio of institutional structures, laws, rules, informal norms, and, most importantly, behavior. Should we want this investment to be more like a portfolio of Treasury bills or more like a portfolio of equities?

With the Treasury bill portfolio, there would be no defaults or losses, steady and utterly reliable receipt of income, comfortable certainty, no scandals, and a real return of 1 percent or so.

With the equity portfolio, there would be some total write-offs, some heavy losses, uncertainty and volatility, and a certain number of scandals and swindles. There will also be some enormous successes and upside results

far beyond expectations. The average real return will be 6 or 7 percent.

Which should a free society prefer?

The Safekeeping Self vs. the Experimental Self

George Prince, writing on the psychology of creativity and the behavior of organizations, suggests that each of us is composed of two competing selves: the “Safekeeping Self,” dominated by fear of loss, and the “Experimental Self,” oriented to possibilities. His characterizations of these two include the following:

- Safekeeping Self: censors; avoids surprises, wrongness, and risks; makes rules; punishes mistakes; and is serious, cautious, suspicious, fearful, and alert to possible danger
- Experimental Self: takes risks; breaks rules; recognizes patterns; sees the fun in things; makes impossible wishes; and is curious, intuitive, and impetuous

If we think of this in terms of corporate governance, it is easy to see which side contains the prevailing traits of accountants, auditors, lawyers, regulators, bureaucrats, examiners, IRS agents, and authors of corporate governance checklists. The tendencies on the other side characterize entrepreneurs, marketers, innovators, and visionary leaders. Both sides are necessary; how to achieve the right balance and interaction between the two is the issue.

This is true for a board of directors as well as other groups, and for the interaction of managements and boards in the governance of corporations. No great companies were created by independent boards, but independent judgment of directors is essential. We do not want experimental auditors, but we also do not want the auditors in control.

“The ideal is to have two selves that cooperate fully,” Prince writes. But also: “We know from observation of groups that a punishing person greatly reduces the production of ideas. . . . If I have a strict and punishing self looking over my shoulder I will be hesitant to take risks. . . . To the degree Safekeeping dominates, it tends to shut down my Experimental Self.”⁸

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Knowledge vs. Independence

Here is Warren Buffett again, discussing the “failings of ‘independence’”:

The current cry is for “independent” directors. It is certainly true that it is desirable to have directors who think and speak independently—but they must also be business-savvy, interested and shareholder-oriented. . . . Over a span of 40 years, I have been on 19 public company boards (excluding Berkshire’s) and have interacted with perhaps 250 directors. Most of them were “independent” as defined by today’s rules. But . . . their contribution to shareholder well-being was minimal at best and, too often, negative. These people, decent and intelligent though they were, *simply did not know enough about business and/or care enough about shareholders*. . . .⁹ (emphasis added)

The most diligent directors cannot possibly match the detailed and specific knowledge of an enterprise, its operations, risks, and opportunities, which a competent management must have. If they did, they would be the management, not the board. To acquire a corresponding knowledge, they could not be part-time, and therefore they could not be independent.

Thus we have another interesting trade-off—knowledge vs. independence—which was discussed acutely by Walter Bagehot 130 years ago:

All which the best board of directors can really accomplish is to form a good decision on the points which the manager presents to them and perhaps on a few others which one or two zealous members of their body may select for discussion. A meeting of fifteen or eighteen persons is wholly unequal to the transaction of more business than this. . . . Not only would a real supervision of a large business by a board of directors require much more time than the board would consent to occupy in meeting, it would also require much more time and much more thought than the individual directors would consent to give. . . . Directors of a company cannot attend principally and anxiously to the affairs of a company without neglecting their own business.¹⁰

Bagehot continues, “An effectual supervision by the whole board being impossible, there is great risk that the whole business may fall to the general manager.”¹¹

The “imperial CEO” in 1873! But we do not follow Bagehot to this pessimistic conclusion. Although directors cannot, by definition, match management’s specific knowledge, they should bring a general knowledge relevant to the business in question, sufficient stature to confront and address situations which do not make sense in the context of their experience, and sufficient experience to be meaningful counselors in matters of importance. This is indeed a significant role. It depends on a combination of relevant knowledge and independence of the right kind.

Buffett gives us a clear statement of what the latter means:

True independence—meaning the willingness to challenge a forceful CEO when something is wrong or foolish—is an enormously valuable trait in a director. It is also rare. The place to look for it is among high-grade people whose interests are in line with those of rank-and-file shareholders—*and in line in a very big way*.¹²

In other words, the corporate governance principle leading to meaningful independence—as well as a meaningful incentive to develop knowledge and commit time and thought to the affairs of the company—is for the director to be a significant shareholder in the company, with significant personal assets at stake.

Buffett concludes, speaking to Berkshire shareholders, “The bottom line for our directors: You win, they win big; you lose, they lose big. Our approach might be called owner-capitalism. We know of no better way to engender true independence.”¹³

This is quite a different and far better concept of “independence” than contained in typical discussions of the term in the aftermath of the bust.

What Committees Can and Cannot Do

The best board of directors is still a part-time committee, with the limitations so well explained by Bagehot. Committees can do some things very well if well led and structured, but committees—especially part-time committees—cannot do some other things at all. Society needs corporate governance principles that recognize these realities. Things committees can be good at include:

- providing oversight;
- reviewing and approving proposals;
- confronting unwise or ill-prepared proposals;
- reviewing performance;
- addressing poor performance;
- asking questions; and
- providing advice and counsel.

But committees cannot:

- create new businesses;
- exercise charismatic leadership;
- generate intellectual insight; or
- discover, create, or seize entrepreneurial opportunities.

And, of course, a committee, let alone a part-time committee, can never manage an enterprise.

In overall perspective, two essential functions for the success of an enterprise are:

- discovering and seizing opportunities; and
- avoiding big mistakes.

All growth, productivity, and progress are derived from the first. Since “all committees are cautious,”¹⁴ they are especially useful in the second function with their oversight, review, and advisory activities.

However, if trying to avoid mistakes becomes the dominant function, the result is bureaucracy, defensiveness, and the hypertrophy of the Safekeeping Self.

If companies, instead of playing to win, play not to lose, society as a whole will not win.

Two Kinds of Mistakes

In the aftermath of the bust, the focus is on notorious fraud and swindling and the punishment and humiliation of the guilty. Engaging in fraud is one kind of mistake: “independence” is the proposed corporate governance answer.

But a more common and economically more important kind of mistake is honest error. The corporate governance answer to this is knowledge and judgment.

Turning again to the marvelous Victorian rhetoric of Bagehot:

A manager sometimes committed frauds which were dangerous, and still oftener made mistakes

that were ruinous. Actual crime will always be rare [but] sometimes we must expect to see it: the magnitude of the temptation will occasionally prevail over the feebleness of human nature. But error is far

more formidable than fraud: the mistakes of a sanguine manager are far more to be dreaded than the theft of a dishonest manager. Easy misconception is far more common than long-sighted deceit. The losses to which an adventurous and plausible manager, in complete good faith, would readily commit a bank, are beyond comparison greater than any which a fraudulent manager would be able to conceal. . . . If the

losses by mistake in banking and the losses by fraud were put side by side, those by mistake would be incomparably the greater.¹⁵

“Independence” without knowledge on the board of directors will not be able to prevent either fraud or honest mistakes, however well-intentioned and honest the directors themselves. Independence in the Buffett sense, combined with the relevant knowledge, will have a better chance.

Concluding Thoughts

What does society want from corporate governance?

It obviously does not want to be defrauded or swindled or to have the swindlers go unpunished. It will especially demand this in the aftermath of burst financial bubbles. But much more importantly, it wants continuous innovation, risk-taking, and creativity, which are the source of its economic growth and well-being.

Burdens imposed on everybody in fevered response to the malefactions of a few have to be constrained by their monetary and opportunity costs. Just as individuals and groups must balance their Safekeeping and Experimental Selves, structures and practices of corporate governance have to balance between trying to avoid mistakes, whether of dishonesty or honest error, and creating opportunities.

The single most effective corporate governance reform would be to ensure that corporate directors have significant personal holdings of the stock of the company of which they are directors. This means outright ownership of shares, not stock options.

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Armed with this source of independence properly understood, relevant knowledge, and incentives to commit time and thought, they should consistently ask two key questions about the enterprise:

1. Do we know what we're doing?
2. Is somebody lying?

In most cases, the answers will be respectively Yes and No. But if the answer is ever No to question one or Yes to question two, the time for confrontation and true independence will have arrived.

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Notes

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9. Berkshire Hathaway, Inc., *2002 Annual Report*, 17.
10. Walter Bagehot, *Lombard Street*, 126.
11. *Ibid.*, 127.
12. Berkshire Hathaway, Inc., *2003 Annual Report* (Omaha, Neb.: Berkshire Hathaway, Inc.), 9.
13. *Ibid.*, 10.
14. Walter Bagehot, *Lombard Street*, 128.
15. *Ibid.*, 127.