THE BROOKINGS INSTITUTION

THE PURPOSE OF THE CORPORATION

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P R O C E E D I N G S

MR. WEST: I'm Darrell West. I'm vice president of Governance Studies here at the Brookings Institution, and I would like to welcome you to this forum on the purpose of the corporation.

As many of you know, corporations have had a long and varied history. Many were chartered and given special privileges in order to accomplish public purposes. This included things such as building roads, dams, and canals. Even when corporations were formed for private purposes, many corporate boards and management tended to focus on the longer view of building great companies that could serve the longer term interests of shareholders and the nation.

Some observers, however, are wondering if the current focus has shifted too much in favor of maximizing short-term profits for shareholders. Companies have special privileges and this raises the question of what benefits and obligations accrued to an enterprise as a result of incorporation. What is the purpose of the corporation? What are the duties and the responsibilities of corporate officers and directors?

Today, we are pleased to announce the launch of a three-year project on the purpose of the corporation. We will be undertaking research and holding quarterly forums on various aspects of corporate purpose. Our goal is to bring together leaders, including lawmakers, corporate executives, university leaders, and representatives from the nonprofit community. We want to promote a broader discussion of the purpose of the corporation and help to inform policymaking and public discussions over the next few years.

And I'd like to thank Bill Buddinger for his generous support of this project. Bill is there in the middle of the crowd. Bill is an amazing guy. He's a smart and visionary individual who is concerned about the wellbeing of the country. I've had great conversations with him over the years, and we really appreciate all that he has done for us. So, please join me in expressing our appreciation to Bill. (Applause)

Now, to address these topics we have put together a distinguished set of speakers. Our keynote speaker today is David Langstaff. He is the CEO of TASC, an advanced system engineering, integration, and decision-making support company for the intelligence community. Prior to that position, he was CEO and co-chairman of Olive Group, a global provider of integrated security and risk mitigation. He also has served as CEO of Veridian Corporation and executive vice president of Space Industries International. He is a visionary leader who has thought a lot about corporations and the role that they play in society.

Following his presentation and audience discussion, we will hear from several other speakers. Constance Bagley is professor in the practice of law and management at Yale University. Her research interests include the study of entrepreneurship, business and legal strategies, and risk management, among other topics. She is the author of *The Entrepreneur's Guide to Business Law, Managers and the Legal Environment,* and *Winning Legally: How to use the Law to Create Value, Martial Resources, and Manage Risk.*

Tom Donaldson is the Mark Winkelman professor at the Wharton School of the University of Pennsylvania. He has written broadly on subjects such as business ethics, values, and leadership. His books include *Ties that Bind: A Social Contract Approach to Business Ethics, Ethics in Business,* and *Ethics in International Business*. I was curious when I saw that how much overlap between there is between those two things, but, you know, the U.S. versus the international.

Lynn Stout is the Paul Hastings Distinguished Professor of corporate and securities law at UCLA. She is an internationally recognized expert in the fields of financial derivatives, law and economics, and moral behavior. Her most recent book is *Cultivating Conscious: How Good Laws Make Good People.*

So we're going to start with David. So, we'll here from him and then I'll give you a chance to ask him some questions as well.

David. (Applause)

MR. LANGSTAFF: Got to balance my liquids.

Well, good afternoon. I appreciate you being here in this coveted, right after lunch position. Hopefully this subject matter will keep you very focused.

Darrell, thank you. I appreciate the opportunity to share my thoughts on this topic. And Bill, where you are, thank you for sponsoring this. And I also want to thank Judy Samuelson, who is here, the founder of the Aspen Institute Business and Society Program, who has done a lot of thinking on this subject.

So, purpose of the firm. It is so basic and sounds so simple, yet I believe that the lack of attention to this topic is one of the fundamental causes of the problems society is having with business today. It's one of the leading contributors to why business is at or near the bottom of the trust scale. So, how we address this topic is fundamental to the kind of political and economic systems on which our society is based, and the values by which we choose to bind ourselves together.

An open question is whether we can pull ourselves out of our self-absorbed, somewhat myopic tailspin long enough to realize that we all have a permanent interest in preserving the system that gives us the freedoms we now take for granted.

We need to remember history and reread a page from 19th century England. “The Tragedy of the Commons” occurred when individual farmers were permitted to graze their animals on the common lands, but there were no regulations to protect the land from overuse. Certain individuals profited by turning out more animals onto the common land, but what resulted was overgrazing to the extent that eventually rendered the commons useless for the community, and the pursuit of unchecked individual self-interest effectively destroyed the system.

Today, corporate purpose is being held hostage by the myth of shareholder primacy. As a society, we've got to decide whether we are to embrace a property, or solely economic view of the corporation, or a citizenship view. If we choose the former view, that the purpose of the corporation is for its shareholders, we are on a path to replay “The Tragedy of the Commons” and we all lose.

It becomes our own Faustian bargain where we sacrifice our societal soul for short-term yet unsustainable gratification of the few. In the long-run, we destroy our own motivations, beliefs, and trust in each other and in our institutions. If we embrace the latter view, the citizenship view, we can regain the path where business is a trusted and responsible member of society, delivering for all its constituents including its shareholders.

So in the next few minutes, I'll look at corporate purpose from four angles; a legal perspective, good business practice, human motivation, and societal requirements. I'll then summarize as to why this topic is so important and why I see it as literally the forgotten brick in the foundation of good capitalism.

Why do companies exist and for whom do they exist? So I'm keen to hear Lynn Stout's thoughts. She is one of the foremost and most thoughtful thinkers on this topic in academic legal circles. So, let me begin by quoting Lynn, the Paul Hastings distinguished professor of corporate and security law at UCLA. She has written that, "United States corporate law does not and never has required directors of public corporations to maximize shareholder wealth. To the contrary, as long as boards do not use their powers to enrich themselves, the law gives them a wide range of discretion to run public corporations with other goals in mind, including growing the firm, creating quality products, protecting employees, and serving the public interest. Chasing shareholder value is a managerial choice, not a legal requirement."

The corporate charter is granted by society and grants limited liability protection to the managers and owners of the corporation. The expectation is that in return for liability protection and other rights, the corporation will make a positive contribution to society. As clearly stated by Edwin Gay, the founding dean of the Harvard Business School, the role of the company is to do well for itself by doing well for society, to do both well and good, and for business leaders to make a decent profit decently.

Today, the question of corporate purpose plays out in the legal context in the debate between shareholder and multi-stakeholder primacy. There are many who will vehemently argue that the driving, even sole, purpose of the corporation is to maximize profit for its shareholders. But let's be clear on this point. It was Milton Friedman, not corporate law, who wrote more than 40 years ago on the social responsibility of businesses to increase its profits that the sole purpose of the corporation is to maximize profits for its shareholders.

The cases cited by supporters of the shareholder primacy theory include the 90-year old *Dodge v. Ford*, and the more recent *eBay v. Craigslist*. Yet, if you read these cases they actually don't make the point shareholder primacists want. Yes, a corporation should make a profit for its shareholders, but the courts recognize and respect the business judgment of directors. This business judgment standard opens the door for more balanced and reasoned considerations and actions. Practically speaking, in our litigious society today it may be your safest of safe harbors to act to maximize profit for shareholders, but it is not your legal obligation.

The debate will continue and I expect some of these points will be addressed by the panelists that follow, but allow me to be so presumptuous that it really doesn't matter how it lands. Although certainly important from a legal perspective, it is less so from the standpoint of how one responsibly operates a business. The reason I believe the legality of shareholder primacy isn't the argument we should be having is because over time, these two perspectives converge. Stated another way, I would argue that pursuing a multi-stakeholder approach to running a business will, in fact, deliver the best returns to shareholders over time.

The issue, of course, is time. And this notion of time and what "over time" means, it merits far more attention than it has received, and I believe it is at the root of the problems, both real and perceived, that business faces today. So, I'll be the first to note that delivering the best results so shareholders over time means that it may not deliver the maximum return to current shareholders next quarter.

But this point takes us to the question of what constitutes good and responsible business? What are the metrics of good business? Wall Street focuses on financial output metrics; profit, profit this quarter versus last quarter, profit this quarter versus the same quarter last year, revenue growth margins. Again, I won't argue that these metrics aren't important, but I will strenuous point out that these results are just that, results of doing other things very well.

There is no business from which to derive a profit without customers. To deliver for shareholders, every company first should ensure that the business continues to offer something that somebody wants to buy, and then focus on delivering for customers. It is the focus on customers and on the inputs that drive performance, that are more aligned with corporate purpose. The link between a clear purpose and vision and desirable operating results is strategy.

So today, I serve as CEO of TASC. We are reestablishing ourselves as an independent company, having existed for the last two decades as a division of a number of companies, most recently part of Northrup Grummond. As a government contractor, we're taking these steps in a market environment that is facing gale-force headwinds in the form of potentially trillion-dollar budget reductions over the next decade.

We have established our purpose and vision and set a strategic intent that establishes task as a preeminent company at what we do, which is high-level enterprise and systems engineering, mission architecture and design in the national security and public safety markets. Our purpose is to strengthen the security, safety, and basic values of society. Our vision is to be viewed as the most trusted, responsive, and valuable long-term partner of our customers, particularly during these difficult times, and our strategy will require time to play out. It is a strategy designed to build sustainable, long-term value for our constituents, beginning with serving our customers best. The performance metrics that matter to us are not the typical Wall Street trailing financial output indicators. Instead, they are the metrics that reflect industry thought leadership, high customer satisfaction, low employee turnover, increasing market share and traction in changing our business model to delivering more solutions-based offerings rather than cost-based services. These are the metrics that will tell us if we are making progress in achieving our longer-term goal of building the leading company in our industry.

Now, I have two great advantages in running TASC. First, we are a private company. And second, I've a thoughtful and engaged board of directors. The first should not matter, the second is critical.

In today's business environment there is a great advantage to being private. I have the time and space necessary to do what is right for the company. Public companies don't often enjoy such time and space. So, it would be easy to say that a private company backed by sophisticated private equity can take this long view and that a public company cannot. But, having served as the CEO of both private and public companies, I reject that point of view.

The key to the solution of this problem of excessive short-termism, and everyone pointing a finger at everyone else, is having a thoughtful and engaged board of directors. A lot has been written, discussed, and debated over the last decade as to the role of the board in business today. Many boards have fallen into the trap of believing their primary role is one of ensuring compliance. This role, while necessary, is insufficient. Boards must spend more time looking forward, not backward. They must spend more time on matters of strategy and direction, and by doing so they open up both time and space for responsible decision-making.

The role of the board is to ensure that purpose, vision, and core values are in place, and then to give the CEO and executive team the time and space to act responsibly. Boards must understand and support company strategies, confirm the metrics that will indicate both success and progress, and hold the CEOs accountable for performance. Boards also must help CEOs counter the short-term pressure of the market and ensure that companies do not make short-term, accommodating decisions that are not in its long-term interest as responsible contributors to society.

To date, boards have become too compliance-oriented and are insufficiently grounded in company purpose, vision, and strategy and are too quick to buckle to the short-term market pressures, thereby denying CEOs and executive teams the time and space necessary to run the company in a responsible fashion. Said another way, boards of directors must step up to the whole job, not just the easy part.

The role of the CEO is to ensure that appropriate strategies are in place and aligned with the purpose and vision, and then to execute, balancing all the conflicts, tradeoffs, and constituent needs in all timeframes in a fair and appropriate way.

Unfortunately, many CEOs do not show the necessary leadership, and instead have been co-opted by the short-term market forces and interests of its financial investors.

So in the end, one cannot escape the need for judgment. At some point, orienting around long-term value creation needs to show itself by delivering near-term benefits, and boards must have the wisdom to know when to hold the CEO who explains away poor short-term performance with claims of building for the long-term accountable for what is, in fact, inadequate performance.

This is why progress metrics agreed to by the board and CEO are so important. To use a baseball analogy, the CEO as batter shouldn't be benched for taking the first strike. The CEO shouldn't be benched for striking out from time to time. But over time, the CEO needs to show she or he can bat and deliver for the team. In this analogy, the board is the manager and needs to know when and how to make the call. The crowd, or Wall Street, will react with every pitch and voice their collective opinion, but in the end within any at-bat or game, it's not their call.

Let me now turn to the human side. Have you ever considered how much time, money, and focus is spent on improving corporate productivity by focusing on inventory management, supply chain streamlining, throughput, and production analysis, quality programs, and such? What surprises me is not that these topics are the focus of business experts and consultants, but that there is so relatively little attention paid to the topic of human engagement and improving human productivity.

What does it take to motivate human beings? If you are the sole proprietor of a business, do you think that you can motivate your employees for maximum performance by encouraging them simply to make more money for you? That is effectively what an enterprise is saying when it states that its purpose is to maximize profit for its investors.

Let me give you three examples to illustrate the point. First, think about leading a community-based volunteer organization. You don't have money, you don't have employment contracts, and often you don't have titles, but you still need everyone to contribute. Further, in our day and age no one has time for anything and everyone can walk away. What holds people together is the fact that they are managed and led with respect, have a clear goal, and most fundamentally a compelling purpose in which they believe.

On this point, I think Aristotle was right when he said the human being is, by nature, a social animal and is most fulfilled by engaging with others. There are great leadership lesson for business in the realization of this simple point.

Early in my career I joined a company called Space Industries where I had the good fortune to work with some of the leaders of the nascent U.S. space program, the people to whom President Kennedy turned to put a man on the moon: Bob Gilruth, Max Frischet, Chris Kraft, to name a few. I was struck by how these accomplished people would speak about the *Apollo* program. How it represented the most satisfying time of their lives. The reason? They were contributing to something that mattered; they were part of a grand adventure that was bigger than any one of them. They had a sense of contribution, responsibility, and purpose that went well beyond their paycheck. Something at the most human level was being addressed.

I expanded on these lessons in building Veridian, and I bring the same approach to TASC. It is clear to me that a meaningful purpose matters deeply. It is the key to unlocking employee commitment, building a positive operating culture, enhancing productivity, and ultimately delivering exceptional performance. Most important, a clear purpose provides the foundation for institutional values.

When your business depends upon attracting and retaining outstanding people, offering an environment where people are able to commit to a higher purpose than simply their job and aligning institutional with personal values in such a way that neither is compromised. It's what the *Apollo* program did for those who worked on it in the 1960s. It addresses a basic human need, and frankly it amazes me that more corporations today don't understand these connections, nor see the benefits.

It may be helpful here to distinguish between the purpose of the firm and the nature of the firm. Those who think the purpose of the firm is to maximize shareholder value also typically think the nature of the firm is as an economic entity in which people are rational, economically self-interested actors. The purpose-driven, multi-staker perspective that I embrace views people as social animals and views the firm as fundamentally a social institution as well as an economic institution. In these firms, the foundation of the firm is meaning, identity, and trust rather than simply economic self-interest.

By creating a meaningful purpose, engaging employees, and attending in a reliable and responsible way to the relationships with all stakeholders, corporate leaders can unleash higher levels of personal energy and establish relationships of trust which can enable their enterprises to out-perform other firms over time.

As work becomes more knowledge-based and as corporations must build the capacity to collaborate across more complex boundaries, understanding the firm as a social institution becomes ever more important. This line of thinking reflects the research of True Point, as outlined in its recent book, *Higher Ambition: How Great Leaders Create Economic and Social Value.*

My point is this: together purpose and values give you something to stand for in your life. Without knowing what you stand for, you are like a ship without a navigation system. You will have no basis for your own ethical grounding, and therefore no basis for ethical decision-making. Institutions are no different. Clarity of purpose and strong institutional values means you have the ends and means covered and you have created the context and foundation for a strong business that acts ethically, is a morally responsible member of society, and delivers for its constituents -- all of its constituents.

So now, let me look at the purpose of business from a societal perspective. As a society, we must ask what do we want from business. This question takes us back to the original compact that established the corporate charter, and we can answer this question. We want business to be a positive contributor to society, now and in the future, in a fair and responsible way. We want to trust business and believe there is some form of moral compass to enable it to do well and do good as an ethical member of society.

There is an obvious and magnificent virtuous cycle. Business is granted a charter, given protection from liabilities in order to encourage it to take risks, offer employment, develop and distribute new offerings, and contribute to an improved quality of life and standard of living in society for all its members.

But today, this cycle is straining not to collapse. In fact, the cycle is now taking a negative turn. Business acts in the short-term interests of its financial investors, leading to what the public considers outrageous short-term decisions that favor the few over the many. We are selling our Faustian soul. The public reacts, laws are passed, and the constraints on business increase. It now becomes harder for businesses to make decisions and deliver the good of business.

The system has raced to its lowest common denominator point, with society obliged to set constraints for all in order to address the short-sightedness of the few. It becomes harder to do good business because trust has been lost.

We are seeing our modern day version of the Tragedy of the Commons play out. Each party is acting in accordance of its own short-term self-interest and no one is taking responsibility for the commons. The collapse of time to the short term is destroying the system. As the Honorable Leo Strine, chancellor of the Delaware Courts, has noted, we don't have time to relearn the lessons of the 19th century.

What I've tried to do in these few minutes is to underscore the following rather straightforward points. First, we cannot forget the basic quid pro quo relationship between business and society, that business exists to deliver value to society and has granted certain rights and protections in order to do so. So ingrained is the notion of shareholder primacy that we have forgotten that business was never intended to be solely for the purpose of enriching its financial shareholders.

Second, from the perspective of basic human needs, purpose helps give one's life and work meaning. Having purpose addresses the basic human desire to be part of something important, something greater than one's self. Combined with strong values, purpose enables corporations to stand for something, thereby providing a foundation for ethical decision-making and moral behavior. Third, an understanding of purpose introduces time as a variable in decision-making. Over time, the goals of delivering a fair return to shareholders and delivering to the expectations of other constituents converge. The objection today is that business is acting in the short term for the benefit of one constituency at the expense of the interests of others. A clearer focus on time as a variable provides a way to push back against the pressures of short-termism.

And finally, a greater emphasis on purpose creates the space for responsible leadership. Boards and CEOs have a shared responsibility to establish a clear vision and strategy for a company, and then to develop the metrics that will indicate whether the company is making progress. These metrics will be different from standard Wall Street trailing financial metrics. They will be based on a nuanced understanding of the business goals that boards must have.

Since no vision can be achieved in a quarter, this kind of board engagement around strategy, not compliance, creates a space that allows a CEO to make the necessary and constant tradeoffs amongst constituents and across time to run the business responsibly. The board must hold the CEO accountable, but it also must push back on the near-term market pressures and give the CEO space to do his or her job well.

So, I'm struck by how often the way forward to meet these difficult, messy challenges comes down to leadership. We might agree that one of the fundamental causes of the problems we face today around lack of business trust is self-interest being defined in the short-term and actors making decisions that generate short-term returns for the financial constituent at the expense of the longer-term benefit for all. The pressures for the short-term behavior are real and many, and in many ways simply reflect the current instant gratification values American society seems to have embraced today. In the end, however, absent laws that force changed behavior -- laws that more often than not seem to lead to a new set of negative unintended consequences -- we must look to stronger leadership in the executive offices of business and from the boards of directors of companies.

Society needs business at the table contributing as part of the solution to the problems and challenges facing all of us, not just sitting in the corner counting its money. With some notable exceptions, the voice and presence of the business leader over the last decade have been strikingly absent. Business leaders need to step forth and be more actively engaged in finding the shared middle ground that we must find if we, together, are going to protect the commons.

Understanding and recommitting to a shared understanding of the purpose of the corporation is a place to start. Thank you. (Applause)

MR. WEST: Okay. So, David, first of all thank you very much for joining us. A terrific set of remarks, and I think you've helped us launch this whole series in a very eloquent sort of way.

I was struck at the very end of your talk how you ended with a call for action. That you said, business leaders needed to step forward, they needed to become more actively engaged in pursuing the commons. So, I have a couple questions just to get the conversation going.

What specific thing should they do? Like, if you're advising a CEO, what one, two, or three things would you tell them to do? And then the related question is is there any CEO out there who is actually doing what you advocate?

MR. LANGSTAFF: Well, I think the most important thing a CEO can do is engage the board. And in fact, if the board doesn't raise this issue of purpose, the CEO should do that. And I have found that it's actually not a difficult conversation to have, partly because people may not realize the significance of what they're talking about. And so, by engaging around purpose and setting a purpose, I think what that serves to do is set a marker out there that allows -- that starts to create that space that I talk about. And then it's a matter of saying, all right, if that's our purpose what are the steps that we -- what's our vision and what are the steps we need to take to get there?

So, it's putting together execution plans in the context of a long-term strategy, rather than simply executing quarter by quarter. And I don't think companies do that enough.

You asked about CEOs?

MR. WEST: Yeah, is there anybody actually doing this?

MR. LANGSTAFF: I think you've got -- I think there are good examples.

There's been a change at Beckton, Dickenson. They're a company that has really embraced this notion of purpose. I don't recall the name of the current CEO. Campbell Soup has also sort of embraced this.

There are a lot of people that, in fact, do this and are able to do it as public companies. I'm having a Rick Perry moment; I'm not going to be able to give you my list of three CEOs. (Laughter)

MR. WEST: Oops. That's okay. Now, presumably some of this could happen through voluntary changes, but are there any policy or legal changes that should be considered to encourage companies to act in this manner?

MR. LANGSTAFF: Well, this is the work that Judy Samuelson has led for many years at the Aspen Institute. I mean, the process has been engaging with CEOs who then tend to point to the market made me do it. And so, one invites, then, the institutional investors to the discussion.

And what you find is that everybody is complaining about the same thing. Initially, people wanted to solve the problem themselves, but I think increasingly are beginning to recognize that we need to perhaps have some legislation to encourage it.

The Aspen Principles lay out some. I mean, there's been talk of restructuring capital gains tax so that there is on a progressive basis a higher tax in the event that you hold a security for less time, declining to even zero if you hold it for a long time. So, the capital can be more patient.

There's been discussion about trading taxes or taxes on trading of stocks. There's been some discussion and there's certainly no unanimity on these points about whether there ought to be a holding period on the part of shareholders to, before they can vote a stock there is a lot of focus now -- and I think Lynn and others and Connie can speak to this issue of introducing a higher standard of fiduciary responsibility on the agents, the investors of money, the mutual funds, and others. I think it would surprise a lot of people to realize how light the fiduciary responsibility standards are for big segments of our financial industry that manage money.

MR. WEST: Okay. Why don't we open the floor to questions from the audience? If you would raise your had if you have a question. And if you could give us your name and if there's an organizational affiliation. We have somebody with a microphone coming. There's a question there in the back, if you can go over to this gentleman.

And we'd ask if you'd keep your questions brief, just so we can get to as many people as possible.

MR. STEAD: Thank you. My name is Robert Stead and I'm with Institutional Shareholder Services. And I'm wondering who owns TASC these days? And, you know, are they going to give you -- we deal with a lot of companies that are public companies, but of course there's been a lot going into the private realm. We were owned by private equity. Even as a private company are you going to get the running room that you envision?

MR. LANGSTAFF: Did you like your private equity shareholder?

MR. STEAD: We had several of them. Public knowledge, Hermes and by and large, we did.

MR. LANGSTAFF: The reason I ask -- and I'm unfair to you -- is I think we share one. TASC today is owned by General Atlantic Partners and KKR.

MR. STEAD: That's right.

MR. LANGSTAFF: So if you think about it, these are both, in my view, very sophisticated, very good private equity firms. They're both over 25 years old, and in many respects, private equity gets a bad rap. You could look at private equity today as being the patient capital in the market. And the thing about both KKR and General Atlantic is that they engage and they are giving me the space to do what I've talked about.

And you know, I think the big challenge, of course, is the step of going public. And I've done that once before, when we took Veridian public, and part of the way I dealt with this issue is to be very clear about how I was going to run the company. And I think you kind of get the shareholders you deserve over time, and I felt that the way to deal with this is to be crystal clear about how we would run the company, which was about building sustainable, long-term value. And we go from there.

At the end of the day, you've got to deliver, you've got to perform. As I said, the long-term has got to show itself in some way in the short-term over time, but I think that happens.

MR. WEST: Right there on the aisle is a question.

MS. GOODMAN: Hi, Amy Goodman with Gibson Dunn. There's a movement afoot to give shareholders greater power. We've seen that with say on pay and the Dodd-Frank legislation, and shareholder proposals to give shareholders say over political contributions, and director compensation, and all kinds of other things. How do you think that movement relates to some of the concerns that you have?

MR. LANGSTAFF: Well, it's a very complicated subject, and my first question back to you would be, which shareholder? Are we talking about the long-term value investor who has taken the time to learn about the company and has patiently invested for years, votes regularly? Or are we talking about the hedge fund investor who came in yesterday and who is going to be gone in two weeks? Do we want to treat their voice the same way? Because our system today does.

And you know, I think I'm not sure if more of a voice for shareholders is the answer at all. In fact, I'm pointing the finger more at the board of directors that needs to serve as the buffer between the management and the shareholder. Certainly has to listen to the shareholder. I mean, they're there on behalf of the shareholder. But the shareholder isn't going to be so engaged in understanding elements of the strategy or where investment should be made.

And I mean, there are some folks that'll tell you horror stories about how certain very short-term shareholders are coming in wanting to see reductions in capital investment, in R&D, in all sorts of things in order to generate higher near-term earnings, which will then get a higher value for the stock and then they're going to sell. And then what? So it really takes you right back to, you know, fundamentally which shareholder are we talking about? And if we're really just trying to maximize value for current shareholders without regard to which ones and don't have a long-term interest in the enterprise surviving that takes you down one path. But if you really want that enterprise to keep going, then it's got to be balanced. And I'm not sure a louder shareholder voice is the answer to that.

MR. WEST: Okay, right there is a question.

MR. ELIAS: Hi, my name is Ailey Elias, I'm with Colorado Partners. You spoke about the short-term/long-term issue with public corporations as being focused on market pressure for public corporations. At least within the financial sphere, lots of folks have pointed to a transition of banking from private to public as a major source of financial crisis, of our problems.

Do you think it makes sense to reconsider even that basic separation of management and ownership? Or do you think that's something that we can't really go back to in terms of finance or corporations?

MR. LANGSTAFF: You know, management and ownership -- I don't have a problem with managers owning business. Many -- I mean, this is how companies get started is that people create businesses, they own the businesses. There's certainly alignment there between managers as owners and shareholders. I mean, people are trying to build value.

What I think needs to be looked at, obviously a lot closer, is the degree to which one is putting just huge sums of wealth in the hands of management, which is there for short periods of time. I mean, you know, there's a point at which it's not right. And I think that's what we're seeing, that's what giving legs to this Occupy Wall Street talk. It's clear what they're against, it's not so clear what they're for. But I think what they're for is a basic recalibration of the equity of the system.

So you know, I don't think there's an easy answer that says -- and in fact, I would not sign up to the easy answer that says, you know, management-ownership is bad or management-ownership is good. I mean, it's all in the shades of gray between as you pull it all together.

I think strategy, you know, comes into play here as well. There's got to be a philosophy about compensation and it's got to be tied to what are really the sustaining metrics of the company.

MR. WEST: Okay, right here up front there's a question. There's a microphone coming up for you.

MR. MALLOY: Yeah, my name is Patrick Malloy. I'm a member of the U.S.-China Economic and Security Review Commission. We're a bipartisan think tank on China's setup by the Congress.

As I see this, I'm really happy that Brookings is getting into this issue and I really am delighted with your talk. I think this is a national security issue, and here's the way I see it.

The Chinese had a bad 150 years. They want back, and they figured out how to incentivize our corporations to help them build a very strong economy. And that wouldn't be so bad, except it's at the expense of this nation. And the Chinese are incentivizing in the name of short-term shareholder value for our companies to move manufacturing, R&D, technology, all on being a friend of China, getting good treatment by the Chinese. But it's not in the interest of the people of the United States.

These corporations talk of themselves as global corporations, as if they have no responsibility to this country and the people who provide them all kinds of benefits in this country. So, I think this is a very, very important issue.

I was in --

MR. WEST: Can we get your question?

MR. MALLOY: I was in President Kennedy's campaign in 1960, and I welcome your reference to that. Because what is the purpose of these corporations? They have to have some responsibility to this nation, and I don't think -- I think they are not.

MR. LANGSTAFF: So, let me comment on that. I'm in the national security business, but I'm not an economic protectionist. And in the same way that, you know, we seem to have gotten over the problem of, you know, if you want to build a plant in Kentucky, you know, we're not worried that it's not in Ohio. We're all part of one nation here, and in time we're going to realize more and more our kids do that we're one globe.

The bigger concern I'd have about the Chinese situation is not so much what it's doing to the United States, because, frankly, it doesn't have an obligation to us, but it's what it's doing to its own economy downstream. And I think it's beginning to awaken to some of the environmental issues and such that, you know, again unbridled sort of free market enterprise, if you will, in an economic sense is leading to within China itself.

So you know, business is smart, money is smart, it's going to go to the low-cost player. And we're all on one globe, and I'm for the fact that funds flow where they need to flow. The onus is really on all of us who are running businesses to run them well and merit our existence.

MR. WEST: Right over here is a question.

MR. McCRAY: Hi, Chris McCray, general and social business.

I very much agree with --

MR. WEST: Actually, could you hold the microphone up?

MR. McCRAY: I very much agree with everything you say in terms of the need of sort of multi-win stakeholder model, the sort of long-term view of compounding a purpose. But I do have a problem, which is 10 years ago Brookings got to this stage of looking at things with some publications called *Unseen Wealth, Intangibles Crisis*. And back 18 years ago when I was working with PricewaterhouseCoopers, one of the problems was that goodwill was measured in a particular way, which actually excludes building a multi-win model, excludes multiplying trust flow, and sort of unique purpose.

So, I'm wondering how we can help you in a sense get a new club of professionals and CEOs to restart this.

MR. LANGSTAFF: It's an interesting point, and we could have a much longer and very different conversation and I think at another time about our accounting system. Which if you think about it, is an accounting system designed for industry in the manufacturing stage. And as more and more businesses go to a services model and a knowledge-based business model, a lot of our accounting doesn't really work very well. It doesn't provide the heuristic insights that we really wanted to and what it was intended for.

So, I mean, that's a whole other topic of -- you know, it takes you to the question of metrics. I think it forces -- if you're in the securities business or you're in a knowledge-based business, it forces you to develop the particular metrics and to educate your investors about what they are, which -- so they can understand whether the company's performing well or not. And the old manufacturing metrics don't always work, and goodwill is a function of that.

MR. WEST: Right here?

MR. DONLAN: Hi, Tom Donlan from *Barrons* magazine. If not the shareholder, then who? And how do you select them? A multi-stakeholder model are words that need more definition, it seems to me. Could you elaborate, please?

MR. LANGSTAFF: It's a good point. And you know, then who? But the who can be all of the above. I don't think there's one "who." I mean, in the same way there's not one shareholder. And to the lady's comment earlier which is, you know, the whole question of whether we ought to be treating -- whether all kinds of shareholders ought to have the same kinds of rights.

But, look. The job of a CEO, be it in a public or a private company, is to balance all of these things. And you've got to be clear about -- you know, maybe any company has got to be clear about the who. You clearly all do have shareholders. You have employees. A services business may put more emphasis on employees than perhaps a manufacturing business, don't know. You've got to deal with customers. You know, some are more active in a community. Companies that, for example, are single company or towns that are single company towns, I think there's a very different kind of relationship there.

But you've got to decide who are the constituents that are relevant for you as a company, and then you've got to balance amongst all of them. And at any point in time, you're making a decision for one and against another one. And that's why I say, over time it's got to be fair and balanced.

MR. DONLAN: Could I follow up?

MR. WEST: Sure.

MR. DONLAN: Just a brief follow-up. All the people you mentioned could be shareholders, and corporations could arrange their stock bonus plans to reach out even beyond the employee base. Do you think that would be a sensible way to run a company?

MR. LANGSTAFF: Take it to an extreme. So, take it to an entirely employee-owned company. Then you're going to have employees with different amounts of stock. But what I have found -- and I learned this the hard way, which is by issuing stock options to employees -- and found to my shock that they didn't want them. They didn't care.

First of all, they didn't understand it particularly well. But what attracted them to the business was the mission and purpose of the company. And when you're in the national security business that perhaps happens more often. And so, the stock option just -- you know, we thought we were being so generous. That was not what they wanted. These are people who for the most part were staying with us even though the company across the street perhaps in a different industry was offering them more compensation.

So, it gets back to the human side of this. Which is what's it take to attract and retain key people? And it's not always money. So, I don't think you can go to the extreme of even an all employee-owned company and somehow solve the problem or square the circle.

MR. WEST: Okay, I think we have time for one more question. Right there on the aisle? And then we'll bring up our academic experts.

MR. CHECCO: Larry Checco, Checco Communications. You talked about leadership and trust. It would be difficult for me as a layperson to understand how I can trust somebody who is making 4-, 5-, 6-, 700 times what I'm making, and I think it's hard on the shareholders as well. And when you talked about CEO and commons, it sounded like an oxymoron to me. It's hard to be making 13-, 14-, 15-, $20 million and see yourself as the common man.

My question is I'm surprised that shareholders don't take a more aggressive role here. Every time a financial institution gives out billions of dollars to its top echelon, that's money from my pocket as a shareholder. And I fear -- you talked about boards. I fear that boards are complicit. They're terrible, and we've seen this. I mean, you know, realism is the -- so anyway, my point is, how do we break this cycle? How do we get corporations to understand that they are there for us and their bottom lines equate to our bottom lines as citizens?

MR. LANGSTAFF: You raise a number of points, and I'll make a couple of quick ones. Number one, I think that the CEO of a company should not be the chairman of the board. I think that's an ego issue, and that the function should be separate. And the reason is because the job of the CEO is different from the job of the board. So that's one step that I would endorse.

So, I was chairman of TASC and I resigned my chairmanship role when I became CEO on a matter of principle. They're different jobs. So, I think that's one where we have to recognize that the difference in the responsibilities of the executive team or the CEO and the board of directors.

Now, compensation -- these compensation matters, they lend themselves nicely to sound bites and headlines. But do you bemoan a Steve Jobs for creating a company and owning a lot of stock, and then in time cashing that in and making huge amounts of money? I don't think that's what people are really talking about.

MR. CHECCO: No, but I would criticize an (inaudible ~~00:50:51~~), or I would criticize (inaudible), those people who have taken their companies to the brink of ruin if (inaudible) and then walked away with millions of dollars' worth of (inaudible) --

MR. LANGSTAFF: Well, I --

MR. CHECCO: -- with is a board issue.

MR. LANGSTAFF: Yeah, you're absolutely correct and I think there's a responsibility that's got to be more visibly seen in the way boards handle these sorts of things. In a number of companies, there's no question there's been egregious behavior.

But, I also know folks who will come onboard and basically join a company as, you know, CEOs who will work for $1. They're not -- but they want stock. They believe so strongly in what they can do and all that sort of thing, they want stock --

MR. CHECCO: I don't think that's the norm.

MR. LANGSTAFF: Well, but these are the numbers that make the headlines because it's when those stock options are exercised that they then get reflected as part of annual compensation. Well, it was really never annual compensation but it's humungous. So, I mean, you just have to peel this back. I mean, this is why I make the point about judgment. You've got to peel it back and just look at the circumstances.

And you're right, boards are there as representatives of the shareholders. They should have a more nuanced and accurate insight into the ins and outs of what's happening in the company. That's what they're there for, and to then create the rule set in which the CEOs operate.

I mean, I think there's got to be more responsibility all the way around, and it comes from really separating the functions as a first step.

MR. WEST: Okay. I want to thank David for sharing his thoughts with us. I think you've really laid a lot of issues out on the table. (Applause)

MR. LANGSTAFF: Thank you very much.

MR. WEST: That was terrific. Let me just get your microphone.

So, thank you for joining us. And I will invite our three academic experts up on stage and we will continue the conversation. Thank you for the terrific questions that you had for David, as well. I thought all of you raised very important points.

So, we have a number of academic experts who have studied different aspects of this. We have someone from a law school, a business school, and a management school. So we wanted to get kind of different perspectives from different points of view.

I want to start with Constance Bagley, who teaches at the Yale University Management School. So, you're an educator. You're training the next generation of leaders. So, I'm just curious, how do we teach or what do we teach in management schools about the purpose of the firm? And what should we teach in management schools?

MS. BAGLEY: Great. I appreciate the question and I appreciate being here.

These are critical issues for management education. They really go to the heart of what it means to be a manager. They go to the heart of is management, in fact, a profession of some sort. Should we, as managers, at least have the Hippocratic Oath, first do no harm? Things of that sort.

I think there's been a tendency, frankly, for much of management education to assume as a given without proper analysis that indeed maximizing shareholder value is what is legally mandated. Like Lynn, I've looked at this issue. She's absolutely right that if you, in fact, wade through the cases, the law makes it clear that except in a very narrowly-defined set of circumstances, that there is not an obligation to maximize shareholder value. There is an obligation to manage in the best interest of the corporation, and the courts have made it clear that includes not just shareholders but also employees, bondholders, the community. These broader situations.

But I'd like to go back to your question, sir, with respect to if not the shareholders, then who? Because I think that is a critical question.

I would begin by saying; we're not even managing for the shareholders. We're not managing for the ultimate claimants of this stock. I have money in a 401(k) plan; I'm not individually investing that money. I'm not deciding on what portfolio it's invested. My fund is investing and maybe my fund is investing in a fund of funds. Do we really think that the average investor in terms of institutional investors that now own 70 percent of our securities are in any way reaching back to the ultimate owners to ask, would you invest in this activity, would you not? So, we currently have no effective feedback loop between the people who ultimately will in their pension plans, in their own mutual fund investments reap the reward or lack of reward as a result of what people are doing.

Who are the people making decisions? It's often people who, as has been pointed out, are receiving relatively short-term compensation. One of the adverse consequences of a somewhat technical rule change by the SEC was it used to be if you exercised stock options you at least had to hold the stock for six months before you could dump it without having to pay for short-swing trading. We got rid of that rule if the shareholders approve the plan.

Think of a Ken Lay. We're now saying no one has to have skin in the game. We saw with the derivatives crisis what happens when people don't have skin in the game. So, I think the first question is for shareholders, are they being adequately represented? Why are managers acting this way?

Well, to the extent I know I'm going to be out of a job if I meet analyst expectations -- if I fail to meet analyst expectations -- very strong incentive to make sure I do whatever it takes numbers-wise to go ahead and meet those expectations. Why are analysts doing this? Well, because they, too, are judged based on their performance. A mutual fund operator doesn't perform as expected? Lo and behold, they get kicked out of the higher value fund; they're replaced by someone else.

So, it's this tragedy not just of the commons, but it's a tragedy as was pointed out with the previous speaker, kind of everyone along in the system. So, how are we going to change this?

I think we start with something as simple as, let's at least make sure people know what the rules of the game are, which we're not doing effectively in business schools. I think we at Yale do a little better at some places. We have a stakeholder approach in terms of how we teach our first year students. We have a course on employee, competitor, investor, on customer, and co-equal, of course on state and society.

In the competitor course, I co-teach a course about ecomagination, General Electric, Green Is Green. We try to not bifurcate the ethical into just one class, because you know what? Our kids are smart. They know if it's the ethics class, what exactly they're supposed to be, goody-two-shoes on that particular point. But if it's the finance class or the econ class, it's straight by the numbers. We try to break down some of that type of analysis.

But I think that we also have to think from a policy point of view. You know, what is shortening the capital gains period, what effect has that had on this? What if we were to say to many of our non-taxable pension funds, okay, to the extent you're acting like patient capital, we'll treat you like patient capital. But if you have a turnover rate in excess of X, we're going to start charging you an unrelated business income tax because you're now acting more like a day trader than you're acting like patient capital.

I think there are a variety of levers that we have on the policy side. Directors are critically important. Let's begin by making sure they know that they aren't exonerated from moral responsibility because they entered the executive suite. That the CEO has said, my obligation is to maximize shareholder value, I can't let my own sense of right get in the way, is wrong both as a matter of law and as a matter of ethics.

So, what I encourage and what we encourage our students to do is take more of the Ralph Larson model. When Ralph Larson was head of Johnson and Johnson he was asked, do you want to maximize shareholder value or be a good corporate citizen. He says, yes. I reject the tyranny of the or. We're trying to teach our students, reject the tyranny of the or. It's not that you have someone in place of the shareholders, but you've got to be smart enough, creative enough, innovative enough that you both get the robust financial return you need to get to become head of a publicly-traded company. And at the same time, you are enhancing societal wealth at the same time.

To the extent that there are tradeoffs, to the extent that you're deferring income for your shareholders, I would propose that we have to, at a minimum, disclose to our shareholders that's what we're doing, so it doesn't become a fig leaf for poor performance. But I think it's doable. I think we need to set the bar higher in what our expectations are.

It's not enough to get the financial return. We want adequate SEC reporting and the like, so we know how companies are getting that return. Are they recycling monitors in China and causing birth defects down the river? If so, they should have to tell us about that in their SKs. We should, therefore, be able to identify as customers do we want to buy that particular brand or another? I think there's a lot we can do to help this, both in terms of education as well as public policy.

MR. WEST: Okay. Tom Donaldson teaches at the Wharton School at the University of Pennsylvania. Do you think some of these ideas about corporate purpose played a role in the financial crisis? And in what way do you see them playing a role?

MR. DONALDSON: Well, I mean, I see the model that we currently teach with respect to the purpose of the corporation as a kind of McDonald’s intellectual model where you don't make many hamburgers, but you can make a lot and you can make them pretty well.

This model arose in response to a couple of pressures. One, the pressure to combine what we know about the firm with what we know about economics. And microeconomics fits pretty well with the current model of the firm, which is basically a model that says maximize financial welfare for the owners, the share owners.

It's also very helpful from the standpoint of quantification and doing the kinds of things you need to do to get tenure. In other words, we think of mathematics and quantification as complex, but the irony is if you want to do that stuff well you have to really limit variables. It's a lot easier to run those models if you're talking about a single constituency stakeholder, the stockholder, and a lot easier to run those models if you assume that that owner has only a single valued interest, namely dollars.

Now, of course, we know that the Norway sovereign wealth fund has very different values other than maximization on return of investment. So, it's a simplification and it's not entirely bad. I mean, it does a lot of things. So, that's the model. Did it contribute to the financial crisis? Yes.

I mean, one of the most haunting comments from that -- one you've heard, no doubt -- came from Chuck Prince, at the time head of Citigroup. When the music is playing, he said, you've got to get up and dance. What would it have been like for Chuck Prince to go to the board and say, you know, we're running a lot of collateralized debt through our shop, just as the other banks are. We're making a lot of money on it. But I'm concerned there may be some systemic risk, both for the industry and society. So, I think I'll cut that out. (Laughter)

Well, I can tell you what would have happened. The board very likely would have gotten rid of Chuck Prince. And the board was doing what it should do, from the standpoint of the model that we currently have about the purpose of the firm. It's a model that does not accommodate, for example, cooperation around either societal interest -- think of systemic risk and catastrophic impact it had on the global financial system -- or a systemic risk from the standpoint of the firm as a member of an industry.

So this dance became a kind of macabre dance of death, and yet it was as if none of the participants in this dance could step out because the model that drove them was the model that we currently hold for the purpose of the firm.

MR. WEST: Lynn Stout of the UCLA Law School. How do law schools teach corporate purpose?

MS. STOUT: Oh, this is so embarrassing to admit. We are so unimaginative.

Pretty much, we teach it maybe even worse than business schools. We teach our poor, innocent law students that shareholders are the owners of corporations. Which if you're a lawyer, the minute you look a little deeper you realize is completely wrong. Corporations are legal entities that own themselves; shareholders own a contract called "stock" that is not in any theoretical way different from a bond or an employment contract.

So, we teach them that shareholders own firms. We teach them that the law is to maximize shareholder value. We always cite *Dodge v. Ford*, even though it's almost 90 years old. It refers to a close corporation doctrine that has no applicability to modern public corporations and it hasn't been followed up by any other case since. And in fact, it's never been cited by a Delaware court for the prospect that you have to maximize shareholder value.

And we send our poor little darlings out into the world with this completely false idea, and they have to do what I did, which is suffer the actually business world for 10 years before I figured out that my professors had done me a disservice and taught me the wrong thing. Which gives rise to the question, why are we doing this to our law students? And I think the answer is very interesting. The answer is, first of all, we didn't always used to do this.

One of the things that I find is often not appreciated by people today is that this whole notion of maximizing shareholder value is pretty modern. If you had asked a CEO 50 years ago what the purpose of the corporation was, you would have heard a story very much like David's. You know, we're there to produce good products; we're there to take care of our employees, to contribute to society. Oh and by the way, we want our investors to get a decent return.

That changed, and it changed in the 1970s. And as best I can track, the change is driven by ideology coming from the University of Chicago that was eventually echoed by Kevin Murphy and Mike Jensen at Harvard Business School in their paper on the agency cost theory of the firm. So, it's one of the scary illustrations of how ideas really do matter.

But of course, it took more than ideas alone, I think, to embed this legally mistaken notion in the business world and even in the legal academy. It also helped or hurt, depending on your perspective, when Congress in 1993 changed the tax code to require that corporations tie their executives' pay to an objective performance metric. And if I could get in a time machine and do any single thing that I think might have helped prevent our current situation, it might have been go back to Congress and say, you know that's not a good idea.

I see people in the room are nodding. Some of you actually remember what happened in 1993, and you're sensitive to the consequences. The consequences are that corporations looking for an objective metric -- which by the way, they really hadn't felt they needed much before. They really thought that the directors were actually in a pretty good position to say, you know, this firm is doing reasonably well. We're going to keep the CEO and give him a raise. Or the firm is doing terribly, we're going to mix things up a little bit. But no, boards had to have an objective metric, according to Congress. And what did they pick? They picked stocked price. And you know the rest of the story. They started giving out stock options.

Sandie Weill figured out that he could be lucky as well and smart, and if he just happened to have enough stock options in Citi during a bull market he'd get $100 million. Sandie got $100 million. Everybody else thought they deserved $100 million, too, right? And if they weren't going to get that through natural, organic growth, they might be able to get it by, oh, I don't know, adding proprietary trading divisions and leveraging up their companies and getting into derivative speculation. And you know, the odds are pretty good that if you stayed at the casino, you might win before you eventually lost everything. But that was okay, because your stock options vested in a year or two years or, if they were long-term, they vested in three years.

Okay, I'm going to stop now. But simply by observing one of the correlations, I think, we have to take seriously today -- and it is time to be serious -- is that we've had increasing dominance of shareholder value thinking in the executive suite, in the boardroom, in the halls of Congress. What has that produced for us in terms of outcome?

I'm going to channel Sarah Palin a little bit and say, so, how's that shareholder primacy thingy working out for you? (Laughter)

The reality is we have had a decade for retail investors that even the *Wall Street Journal* now pronounces the "lost decade." We have seen corporations eliminating jobs and outsourcing jobs, to the point where the unemployment rate is now an economic issue for corporations themselves. You can't sell products if you don't have consumers with money.

We've seen a financial crisis that many people trace directly to short-termism and a short-term focus on share price in the newly-incorporated banks that formerly were private partnerships, and there is -- although there's a lively debate, there are lots of people out there who think that American corporations are not making the sorts of long-term investments in research and innovation that historically they've made.

So all I can say is, we're taking the same medicine and we seem to be getting sicker. So, I'm so happy that Brookings is now supporting an inquiry into this question and allowing us to go back and say, was that such a great idea back in the 1970s when we started deciding that shareholder value is the end all and be all?

MR. WEST: Okay. I want to throw out one question for each of the panelists and then we'll go to the audience for your questions. It's the same question I asked David.

Do you think there are any specific policy and/or legal changes that we should consider to change some of the issues that each of you have raised?

MS. BAGLEY: I mentioned that I think in terms of our tax code that I think our holding period for capital gains is too short. I think that there should be some sort of a portfolio turn tax. I would call it the turn tax in terms of when portfolios are being turned over in an excessive amount.

The Delaware courts, I think, have done a good job of making it clear that instances in which you do have to go ahead and realize value for the short-term is pretty limited, but it's as if no one's listening. It's really kind of unusual in that regard, so I think that part of what it's going to take is courage. I think it's going to take leadership.

It's going to take what you were alluding to, Tom.

A business leader saying I know everyone else is dancing, but you know what? This doesn't make any sense to me. It's going to take courage to stand forward. It's going to take institutional investors that are willing to decide who their fund manager will be, other than based on just the last quarterly performance.

I also would go back to something that I recommended back in '99. I think there could be further SEC disclosure about material decisions made by the board that affect any major constituency. So, if I'm selling products that do not meet a safety -- if I'm selling products in Southeast Asia that do not meet a U.S. safety standard, you would have to tell your investors in the 10K -- and that would then become available to customers -- this is what I'm doing. If I'm dumping waste somewhere that wouldn't comply with U.S. law, I've got to tell people.

We've got a massive problem of externalities. We have an economic system that makes sense. I mean, shareholder primacy actually would make sense if we had perfect information and if all costs had to be internalized. But economists will tell you, we don't have that. We have very high transaction costs, so it's not economic for every employee to negotiate an agreement every time they go work for a company, every town to negotiate an agreement, every investor.

So what we've done is we've predicated a system on hypothetical markets that are nonexistent. Not to mention, our behavioral economist folks have now, I think, persuaded most of us that in fact, most people aren't rational. We expect markets to be rational when human beings aren't? Of course not, of course not. So, I think we've got to get back to basic things like to the extent that there are assumptions that have to be made to make your regression analysis run, on the lines of what Tom was saying, and those assumptions are know to be contrary to current fact. We don't put any credence in those models.

So, I think getting information out so at least we can start to price some of these externalities would at least help to out the cheaters. It would mean that if I'm having to compete with someone who isn't spending extra time making sure that their products are safe, I'm not being killed in the marketplace because I charge a higher price for it. So reporting, I think, sunshine is a pretty good disinfecting.

MR. WEST: Tom, any policy and/or legal changes?

MR. DONALDSON: Yeah. Well, I'm going to sing out of tune here just a bit. I think that legal and regulatory reform is important. I'm not one of these people who think that the world would be heavenly if we didn't have government, but there are limits to what government can do.

The knowledge insight in industry tends to race ahead of regulators' capacity to deal with what's known. The hazards of asbestos were known by chemists in the asbestos industry long before regulation could catch up. I would submit that the background dangers of systemic risk in the financial services industry were -- they weren't completely known, but they were known and appreciated much better inside the industry than they were by regulators. Knowledge of the issues of deep water drilling -- think BP -- are known soon.

So, what's that mean? That means that regulation is always condemned to be a couple of steps behind innovations that pose risk to society and the industry. And the solution, to me, is something I call a pelican's gambit. Pelicans, if you study them, are interesting animals. They actually do quite well by themselves. Native Americans used to use them like Chinese used cormorants. In other words, you can tie a string to the leg of a pelican, and that pelican will bring you a fish. As an individual hunter, they do very well. But there are key moments in life in a pelican colony where the competition -- even among males -- turns to cooperation. So, males remarkably will help in gathering nesting material for one another.

And there are key times in industries, I believe where cooperation -- not the traditional model of competition -- has to take hold. This means that in 10, I have to be up at an industry level with respect to risk, leverage, dangers of new technology, and so on. It may require some changes in law, actually, to permit some of those conversations to occur, actually. But for me that's an important part of the puzzle.

MR. WEST: Lynn?

MS. STOUT: First of all, this is a very complicated subject. We didn't get here by making one mistake; we got here by making collectively -- and inadvertently and with the best of intentions -- lots of little mistakes.

So, I think the first place we have to start is by acknowledging it is possible we have made a mistake. And going back and revisiting some of the policies that were put in place over the last 20 years, again with the best of intentions, that I think have actually contributed to many of the problems.

So, I actually find myself saying, you're right. Not only is government not necessarily the solution, I think in many cases it has been the well-intended but mistaken regulatory efforts that have been part of the problem.

So I've already mentioned one, which I think really the IRS and the government needs to get out of the business of trying to figure out how to compensate executives. I realize this is a minority view, and many people's response to recent disasters has been to double-down and say, oh, the problem is just that we haven't designed the right incentives yet.

I would simply say that there was a time when CEOs would work for $1 a million a year and a corporate jet, and it was safer and cheaper than what we ended up with a few years ago. So, I would back off on trying to come up with the silver bullet for executive compensation.

I'm very concerned about regulatory changes that have created this hyperactive market where shareholders hold for such a short period of time. In fact, the average holding period for stocks on U.S. stock markets these days is -- prepare yourselves -- four months. It was eight years in the 1960s. Our holding period is now down to four months average.

Why has that happened? Well, part of it is the development of new technologies and the creation of sort of flash trading computer programs. But a lot of it has to do with the fact that we actually did have transfer taxes, which we eliminated. We had, admittedly, monopolistic, fixed brokerage commissions, which we also with the best of intentions eliminated. We amended the proxy rules in 1992 to make it easier for activist hedge funds to coordinate with each other, to make coordinated wolf pack attacks on particular corporations, which led to the rise of the hedge fund, which is of course almost the quintessential short-term player.

And, we've taken a lot of steps that are designed to increase shareholder democracy in, I think, unrealistic and overly idealistic view that the shareholders who are going to ride to the rescue are the average mom-and-pop retail investors. And the reality is, those people are and should be rationally apathetic.

If you're a diversified shareholder -- and you should be -- you should have something better to do, right? You should have a day job; you shouldn't be spending your time following what's going on at each of the 20 or 200 companies that you have an interest in. But one of the consequences of that is, inevitably, which of the shareholders that are going to organize the shareholder power. It's going to be the short-term shareholders and it's going to be the non-diversified shareholders, the hedge funds.

So we've actually created a system in which, you know, going back to David's fundamental question, which shareholders -- you know, who is the shareholder you want me to represent? We've actually got a legal system that favors the short-term and the undiversified, the Carl Icahns of the world, and disfavored the rationally-apathetic diversified mom-and-pops who are saving for their retirement or their kid's college tuition? That last problem is a very complicated problem. I think it's imminently solvable, but not until we start, hopefully -- and thankfully with the benefit of Brookings -- of raising the public consciousness that it is a problem.

MR. WEST: Okay, let's open the floor to questions. Again, we have someone with a microphone. Right up here, front on the aisle, we have a question.

MR. SMITH: Thank you, Darrell. Bruce Smith, retired. It's been an excellent discussion. I'm trying to connect it to what I think is one of the key sort of macro policy problems, and I like Professor Stout's benign neglect. I think if we could get people disinterested in politics that might help, too. They're hyperactive.

But industry is out there sitting on a great deal of money. And I've been through umptee-ump Brookings talks and I know what my colleagues think, that you can't invest if there isn't profit, and so on. I know all those arguments.

But how do we get business to disgorge some of the profits? Not just to buy back their stock. Now, maybe that makes sense to buy back your stock in some ways, but how do we get economic activity going? Don't you have to take a chance at some point? You can't quite measure what the market is going to tell you, that you can't measure how much demand there is until you actually invest something, hire somebody, try to sell or do something. And how does that kind of macro public policy issue fit into this sort of discussion of corporate responsibility?

MR. WEST: Good question. Panelists?

MS. BAGLEY: We certainly have a way we dealt with it decades ago with private foundations. We essentially say you've got to spend a certain amount of your income every year to the extent you want to be treated as a charitable organization. So, I think there's an interesting question as to the extent that you've got companies sitting on the cash not using it. Do we want that tax the same way as people who are paying salaries, taking entrepreneurial risk?

MR. DONALDSON: I think the problem is unsolvable. I mean, you know, the times are not so good and we're spending less in our family. And times are not so good when I talk with executives. And even though they've got some saved, they're not going to spend it. I mean, unless they think that there's some possibility of making, at least in the long-term, a reasonable return.

So, I mean, you know when Nixon pleaded for help on price controls and so on from business, it didn't work very well. And I think the same is true here.

Am I being too pessimistic, do you think? (Laughter)

MS. STOUT: No.

MR. DONALDSON: You think I am.

MS. STOUT: Yes.

MR. DONALDSON: Oh.

MS. STOUT: All right. We definitely face hard times, but they're eminently fixable if they start with recognizing we have a problem we have to fix. So, you know, I'm beginning to sound like a little bit of a broken record now, but do you know why corporations love to do share repurchases rather than invest? Number one, it's the number one thing that hedge funds ask for. That and selling the company. Empirical studies have shown that hedge funds may dress up their activities by saying, oh, we want better corporate governance, we want this and that. But statistically speaking what they want is either a massive dividend or share repurchase, after which they promptly sell, or they want you to just sell the whole darn company, after which they promptly sell. Why are executives happy to do repurchases? Because their compensation is tied to share price and share repurchases have been proven to raise stock price.

So, part of the problem is the general economy. And you know, just to be fair I was channeling Sarah Palin before, now I'm going to channel Paul Krugman. I must say, times like this make me feel kind of nostalgic for the Civilian Conservation Corps and the Hoover Dam, right? Don't you every once in a while just get that, you know, that nostalgic 1930s thing? If business isn't going to spend money, you know -- since we're printing it anyway, why don't we print it to create jobs instead of printing it to bail out banks?

But, that's above my pay grade. I'm really -- I'll be the first person to admit; I'm a corporate governance specialist, not a macroeconomic specialist. So, I'll just stick with it would really help if we didn't have incentives for CEOs and executives to withhold money and pay it out in the form of dividends and share repurchases, and if it weren't so easy for hedge funds to cooperate with them in demanding just that.

MR. SMITH: That sounds great, could I just add one quick --

MR. WEST: Just very quickly.

MR. SMITH: -- follow-up, Darrell? You get to, then, the question of the politicians. It is said that the climate is bad, that business needs to have a firm climate. And then you look at the politicians and there's a lot of theater so you don't really know whether things are as bad as it seems.

But, can we get a climate where we think the politicians really understand these problems and would be willing to face down their constituents and come out with a decision that makes some sense? Looks like it's there, doesn't look like it panders to business? Can we ever get a "climate" that will encourage investment?

MR. WEST: Well, speaking historically these things have tended to go in cycles. So even though it's a big challenge to get to that point today, there's no reason to assume that there isn't going to be a cycle and things will change, and at some point we'll be more attuned to that.

There's another question right there.

MR. JONES: Hi, I'm Mike Jones. I'm a retired actuary and was part of the ownership structure of a private LLC that went public in an IPO and had a nice opportunity to see both sides of it.

I do think that most of the owners of our corporation after we went public were private investment firms that were in there for institutions investing for the long term, and that was a problem but we solved that.

I think we've laid the basis here in the speakers for a conceptual basis for the corporation going forward, and what some of the technical problems have been and might be solved. I think to me, one of the gorillas in the room, as the gentleman over here pointed out, is accountability. Who is accountable for that CEO who did not recommend to the board, show them the leverage that was going to be caused by the securities that they had, and made awful, awful, awful decisions and yet got paid for it? That accountability has to be done, and I'd also question what is there in the law that says that shareholders or some government agency cannot go back to those situations and punish them somehow?

MR. WEST: Okay, accountability. Don't everybody speak at once, that is so rude.

MS. STOUT: All right, this is a tough question. And whenever anything goes wrong it's easy to want to look for the individual who was in the position to have prevented that thing from going wrong.

But in most of these cases, I don't think this is a case of being able to identify an individual, or even a group of individuals who is insufficiently accountable. I think we have chronic institutional pressures for short-termism, for ignoring the problem of external cost, for ignoring really -- you know, I'm one of those optimistic people who really thinks that most of Union Carbide shareholders, if they'd known that Union Carbide was about to blow up an Indian village and kill 2,000 and maim 10,000 more, would have preferred that Union Carbide not do that. I similarly, you know, am optimistic that most of BP's shareholders probably would have preferred if BP hadn't caused the largest environmental disaster. And I'm with Connie in that I think one of the biggest obstacles is simple lack of information on the part of shareholders.

So, I think in a way accountability easily is -- can become a red herring. I think it's almost as if -- you have to understand, my view at least is that corporations are incredibly large, complex institutions. Many of them are larger than the economies of all but maybe the top 50, 60, you know, nations in the world. And when you reach that level of complexity -- it's like saying who's accountable in a nation-state? I mean, I know the Republicans will say it's President Obama and the Democrats will say it's the Republicans in Congress, but really who is accountable for the current problems we have in the United States?

So, my own view is I take a less personal view of it and a more institutionally oriented view. I think that the problem is the institution is driving people who really would prefer different outcomes toward an outcome that collectively doesn't work for us.

MR. DONALDSON: Just very quickly, I think accountability is a big issue. I think it's striking that nobody's gone to jail in the context of the financial crisis. The average CEO in the United States is paid too much, in my opinion, and it's hard to make a market argument when you live in a world in which the average CEO's salary is, in some other very successful countries, is considerably lower. It's hard to believe that we have to pay all that much.

So, I think you can start with some basic steps. Certainly can have restricted stock awards. I mean, there are techniques that boards can use. The government can try to enforce some of this, but, frankly, if you look historically the record of government attempts to regulate compensation and accountability is unblemished by success. (Laughter)

In other words, it's failed every time.

MS. STOUT: No, it doesn't work.

MR. DONALDSON: So, there's only so much that we can do. But accountability is a critical issue, I agree.

MS. BAGLEY: I do think that there's a real role for the criminal law here. I don't think we want to go the Chinese route, where you get executed if you engage in a

Ponzi scheme. But, I do think that it's the old adage of you only have to shoot one in the herd to get the whole herd to change behavior.

I think there's a question here as to -- that was brought up with the judge who refused to accept the Citicorp settlement agreement with the SEC. It's time for a change from business as usual, you know. I think that there's some very real questions here as to whether there indeed have been violations of the securities laws. Who knew what when? And I, for one, would certainly encourage the Justice Department to drive some of those cases hard, even in the event that you may not be assured to an absolute certainty how it may come out. I don't think you bring cases you don't think you can win, but I do think that based on what we know and have seen in other scandals, my guess is there are quite a few members of the herd out there that potentially could be subject to this.

I think using the same techniques used in the 1980s and early '90s with respect to Milken and the like, you find a couple people on the bottom of the food chain and you start getting people to plead up until you can get the people who actually were at the top making these decisions. You have direct testimony, yes, they were in the room and they talked about, yeah, even though we know this is going to be the result we think we can get off the dance floor before the music stops.

I think there is a very real role here for vigorous criminal prosecution. Because I think ultimately, there are a lot of CEOs that will risk their, you know, golden parachute even though it seems like it doesn't get put at risk, either. But in terms of risking your freedom, as adventuresome as CEOs are, I think most of them don't sign up for that as a cost to be in business.

So, I would like to see more in criminal enforcement.

MR. WEST: Okay. In the very back row there's a question.

MR. DELEASE: Thank you. Mark Delease. I'm with CSC.

There seems to be a trend, a rise in corporations reporting on their triple bottom line, corporate social responsibility, corporate responsibility. I have benefited from that, it's my job now at CSC. And I'm curious as to how you view that. Is it a marketing gimmick? Is it a brand gimmick for these companies? Or are they actually seeing the fact that if they are only reporting on their financial results and not on their social responsibility and not on their environmental impact, they're being too narrow.

So, how do you view corporate responsibility and the rise of that, and the fact that with large corporations almost all of them now put out a corporate responsibility report?

MS. BAGLEY: Enron had the most beautiful corporate responsibility report I've ever seen.

MR. DELEASE: You haven't seen mine. (Laughter)

MS. BAGLEY: I think to the extent that it drives real decision-making and is not just greenwashing, is not just marketing, I think it can be helpful. I like the fact that GE is part of ecomagination. Measures have we, in fact, reduced or own carbon footprint? Have we reduced our own water usage?

Ecomagination may be pure branding for a lot of products, but for me at least the fact they're able to demonstrate that we have monitored and, indeed, we did reduce our carbon use by this or our water use. I think having it verified, though, is critical. And so having proper auditing for it becomes critical, yeah.

MR. DONALDSON: I would say, too, I mean, the question of how we account for the contribution that's other than financial to owners is critical. And it's critical not just from the standpoint of companies throwing out numbers, it's critical from the standpoint of investors who care about this kind of thing.

So, I serve pro-bono as head of the U.S. advisory committee for the FTSE4Good, which is an index. We lack -- I mean, we do the best we can, but numbers are hard to come by. And that technology has to evolve. I take it you're part of that, I applaud it. And I think it's important for investors, it's important for people inside the firm as they try to measure themselves if they're going to take something other than the classical model of the purpose of the firm.

MS. STOUT: And I think I'm just piling on. Lip service to the common good is better than no service to the common good, we'll start there. But I also think that there's a serious investor demand for corporations that contribute to the common good and not just to private wealth. And you know, I use the thought experiment of would you really have rather had Union Carbide turn in a few more pennies and dividends? But we don't have to rely on those thought experiments.

There's actually a vast -- there's a treasure trove of empirical data that actually demonstrates -- and it's really beyond empirical question -- that 97 percent of people are willing to make reasonably small sacrifices in order to avoid harming others and in order to make sure that they're making the world a better place. And by the way, the 1 to 2 percent that don't, that aren't willing to do that? We call them psychopaths. And you can actually see their brains work differently on a brain scan.

So, I think that for a smart corporation this is a great untapped source of investor support. And the key is, auditing and making sure the information is reliable.

MR. DONALDSON: And let me follow that up with some numbers that I think extend the line of reasoning here. A lot of people are shocked to find that nowhere in the world if you survey executives -- and this has been true for half a century -- will more than 50 percent opt for an, in effect, shareholder-only model of the purpose of the firm. The country that always measures highest is the United States, but even there it averages around 30 percent only. If we survey Harvard, Wharton, UCLA business students, fewer than half will opt for that model.

Now, the catch is that the stakeholder model is almost like getting a present for Christmas or holidays and you open it up and the batteries are not included. Right now we haven't -- and this is a job, in part, for academics, for theorists. We haven't worked that model out nearly as well as the classical model. But most of us know at some point, including executives, that there's something wrong. We're just maximizing over that single function.

MR. WEST: The third row from the back, you had a question? Right there, second gentleman.

SPEAKER: I have a few questions, but let me try to limit it.

MR. WEST: Stick with one, because other people want to ask questions.

SPEAKER: Before I came to the United States I studied law at the University of Utrecht in the Netherlands back in the 1980s. And a lot of discussions here would seem to be completely, I mean, practically lunatic in law school at that time.

But one of the main issues, I think -- and you said, you know, you talk about cultural -- the fact that laws keep us slower than what happens in society, technical developments and stuff like that, externalities, et cetera, et cetera. We haven't talked about one of the issues that I think we should talk about, the entire corporate charter.

Are we not at the time when -- especially against the Occupy Wall Street protests -- are we not at the time when we really should start to think more deeply about a complete redoing of the corporate charter? Fully understanding that in a globalized world, et cetera, et cetera, there's always going to be abilities to get around laws, laws are very, you know, complex, all types of exclusions. I mean, I know all of that. You don't need to go there.

But that something that -- what we need is to fundamentally democratize the corporations, to make the corporations a real stakeholder in society. That the people that are a large part of the population benefit by the corporations. You all are talking about the fact that there are trillions of dollars, no corporate profits that are not being taxed anymore to the benefit of no one. Something should be done with that, especially at a time when you are chopping education, et cetera, et cetera, et cetera.

I mean, you know, that's a clear view. I don't want to go too radical here, but a fundamentally democratize corporation that not only looks -- and it should look at shareholder's value. It should look at, you know, giving money to the corporate chiefs and stuff like that. But that for the larger society, you know, in terms of the quality of -- in terms of being a virtuous corporation. I don't want to go play to an Aristotle, but that something else has to be done here. That we need to think in a more complex and a more profound way about what is going on.

Because as you said, ideas are important. Ideas are, indeed important. If the same ideas are being recycled again and with small, minor changes, you know, then we end up basically replaying this game endlessly with the catastrophic consequences to come. And at a time, I think, when what we're seeing now in Europe and here is that people simply are going to reject this corporate model in this kind of capitalist model that we are now living in.

MR. WEST: Okay. So, should we redo corporate charters?

MS. STOUT: Okay, you can just see me squirming with anticipation. This is one of those times I'm glad I'm a lawyer. Every once in a while it's handy.

We've already done that. The interesting thing about corporate charters is that the law of the 50 states generally either allows or permits you to describe your corporate purpose in your corporate charter. And I've read 100 of the darn things.

You know what most of them say? Do they say our purpose is to maximize shareholder value? Absolutely not. I've never seen that. In 20 years of studying corporations I've never seen a corporate charter that says our purpose is to maximize shareholder value, even though there's absolutely no reason why you can't put that in your corporate charter. Which, again, I think just hammers home this point that the law does not require shareholder value maximization.

What almost every corporation does is put the following in: The purpose of the corporation is to do anything lawful. And so, that opportunity to use the charter is there. It's rarely used. However, there are some corporations -- there are corporations that put in their charters that they have other stakeholders' interests as well.

There's a very interesting development in Australia where they've just legalized -- they've made it possible to incorporate law firms. And one of the things you routinely see in some of these charters is that it's not the duty of the law firm to maximize shareholder value. The first duty is to the court, the second duty is to the client, the third is to the shareholders. So, that is certainly an avenue that is open.

My own view is that we don't even need to do it. Once your charter says you can do anything lawful, it's really the view of the boards and the political pressures from the regulators and from the shareholders and from the other stakeholders that are going to determine what your purpose is. So, it's a great idea. Interestingly enough, it's actually already available as an option.

MR. DONALDSON: Were you perhaps talking about the national chartering of corporations, such as the charter could be revoked if it didn't accord with national interests?

MS. STOUT: Oh, sorry. Misunderstood. Your turn.

MR. DONALDSON: No, no.

SPEAKER: (inaudible ~~01:41:07~~) basic things that, you know, should be (inaudible).

MR. DONALDSON: And you can get rid of it, yeah, or --

MS. BAGLEY: Yeah. I mean, we certainly had --

MR. DONALDSON: Revoke its right to exist. Yeah, yeah.

SPEAKER: (inaudible)

MR. WEST: So, do you have a view on that?

MS. BAGLEY: We have a precedent for it. We have the Arizona Statute that I guess the Supreme Court will hear, saying if you repeatedly hire an illegal alien to work, you lose your business charter. So for lesser ills, we have indeed given the death sentence --

MR. WEST: There's a model.

MS. STOUT: Yeah, no. And in fact, that's a model that -- now that I understand your question, history has given us reason to be nervous because the problem is when you give that power to the national government, the pressure it creates for political favoritism and corruption is really enormous. So, I prefer more incremental changes.

MR. WEST: Okay. Well, we'll take one more question right here.

SPEAKER: Thank you. I wanted to come back to Professor Stout; you mentioned the use of outsourcing. My understanding is that U.S. corporations are creating more jobs outside of the country than they're creating in the country. Under our present corporate charter, do they have any responsibility to create jobs and GDP in the United States as opposed to creating GDP in China?

MS. STOUT: The short answer is, no. At the end of the day, the responsibility of the board -- the only -- it's not even fair to call it a legal responsibility.

The only practical responsibility of the board -- well, they have one legal responsibility, which is not to steal from the firm. And in the United States, we're pretty good at enforcing that one. You know, whenever we see these companies about "managers" running off with money, it's not the board of directors, it's the CEO the directors hired.

But other than that, they're allowed to do anything lawful. So their principle directive is to keep the firm alive. And you can understand how, given some economic pressures, that desire to compete and keep the firm alive is going to drive some jobs to be outsourced.

You know, you can't just shut down all international trade. But shareholder value thinking takes that pressure and makes it much worse. There are plenty of situations where a firm would be perfectly viable keeping most of its employees in the United States, and the result might actually be greater wealth generation overall. And right now, shareholder value thinking doesn't allow for that.

MR. WEST: Okay. We're going to make that the benediction. But I want to thank David Langstaff, Connie Bagley, Tom Donaldson, and Lynn Stout for answering these questions and sharing your views with us. Thank you very much.

(Applause)

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