U.S. securities regulations protect investors and enhance market liquidity. But do they alienate managers and shareholders?

Deficient Governance

by Amar Bhide

Without a doubt, U.S. stock markets are the envy of the world. In contrast to markets in countries such as Germany, Japan, and Switzerland, which are fragmented, illiquid, and vulnerable to manipulation, U.S. equity markets are widely respected as being the broadest, most active, and fairest anywhere. The Securities and Exchange Commission strives mightily to keep them that way. Thanks to the SEC’s efforts, trading costs in the United States are half those of any other market. In the twinkling of an eye, Wall Street’s professionals buy and sell blocks of millions of shares. The average American, too, can trade with little fear of rigged markets or insider dealings.

For Main Street companies, however, the nirvana of perfectly fair and liquid markets fostered by Wall Street’s regulators has a dark side. Unwittingly, the system nurtures market liquidity at the expense of good governance. Rules that protect investors and the integrity of stock markets also foster antagonistic, arm’s-length relationships between shareholders and managers. The system prevents shareholders from engaging managers in candid dialogues and providing informed oversight and counsel. It encourages capable executives to neglect their fiduciary duties and thus injures the long-term interests of companies and shareholders. Rules to ensure accurate and complete disclosure, the incarceration of insider traders, and the elimination of shady trading practices may actually hurt U.S. managers and stockholders.

An Extensive Web of Regulation

U.S. rules protecting investors are the most comprehensive and well enforced in the world. The origins of the system can be traced to the extensive losses suffered by the public during the Crash of 1929. Between September 1, 1929 and July 1, 1932, stocks listed on the New York Stock Exchange lost 83% of their total value, and one-half of the $50 billion in new securities that had been offered in the 1920s proved to be worthless. The losses were widespread—the crash followed a decade during which some 20 million Americans took advantage of postwar prosperity and tried to make a killing on the stock market. Responding to the outrage of voters, Congress passed the Securities Act of 1933 and, in 1934, passed the Securities Exchange Act and created the SEC.

Prior to the early 1930s, the traditional response to financial panics had been to let the victims bear the consequences of their greed and to prosecute frauds and cheats. The new legislation was based on a different premise: the acts sought to protect investors before they incurred losses. They did this in three ways:

1. To help investors make informed trading decisions, the acts required issuers of securities to provide information about directors, officers, underwriters, and large shareholders—including remuneration, the organization and financial condition of the corporation, and certain material contracts of the corporation. Issuers were also required to file annual and quarterly reports, following specific guidelines issued by the SEC. Over the years, the SEC’s efforts have substantially increased the number of reports that companies must file. For example, companies must disclose management perks and overseas payments and provide replacement cost accounting and segment, or line-of-business, accounting.

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The acts backed the disclosure rules by providing criminal penalties for false or misleading statements and empowering the SEC to suspend the registration of securities that didn’t comply with the reporting provisions. Regulators also expected assistance from class-action lawsuits. In 1946, for example, SEC officials testified that, notwithstanding "the abuses of 'strikers' and their raids on the corporate treasury," they commended the "prophylactic and deterrent effect of the stockholder suit" and had occasionally urged the courts to adopt "a liberal attitude towards class suits."

2. To discourage insider trading, the securities laws required every officer, director, and 10% equity owner to report the securities they owned. Such insiders had to turn over any short-term trading profits (those that resulted from purchases and sales within any six-month period) to the company. The laws provided criminal sanctions for failure to report such transactions. The SEC has zealously prosecuted the insider-trading provisions of the laws, given wide publicity to their sanctions, and helped federal prosecutors send offenders to jail.

3. To protect investors, the 1934 Securities Exchange Act sought to eliminate the "manipulation and sudden and unreasonable fluctuations of security prices." The laws prohibited several practices, including engaging in transactions to manipulate prices or to create an illusion of active trading, making material false and misleading statements, and spreading rumors about market rigging. Stock exchanges had to register with the SEC, had to agree to comply with the securities acts, and had to help enforce compliance by members. The SEC could deny registration to any exchange that failed to comply with its rules and rapidly used its powers to close nine exchanges. In the late 1930s, Chairman William O. Douglas virtually threatened the New York Stock Exchange with takeover if it didn’t institute reforms.

In further pursuit of frictionless markets, the SEC in 1971 gradually began deregulating stock commissions. After amendments to the securities acts in 1975 made brokerage fees negotiable, commissions paid by large investors declined from an average of 26 cents per share in April 1975 to 7.5 cents in 1986.

Over the years, Congress has also sought to protect investors by regulating the financial institutions that manage funds. For example, the Investment Company Act of 1940, which followed the collapse of investment trusts, set minimum levels of diversification for mutual funds and precluded them from holding more than 10% of a company’s stock. Complaints about the self-serving management and the underfunding of corporate pension funds led Congress to pass the Employee Retirement Income Security Act in 1974. ERISA prohibits pension plans from holding more than 10% of the sponsor’s own stock or 5% of any other company’s stock and specifies conservative rules for pension fund trustees.

The Basis of Market Liquidity

On the surface anyway, the populist regulations to protect the small shareholder, mutual fund investor, or pension fund beneficiary have benefited U.S. companies by sustaining an efficient and liquid stock market. Wall Street’s financiers, who argue passionately for free enterprise, in fact owe a great and unacknowledged debt to their regulators. The SEC reassures speculators (who make market liquidity a reality) by certifying the integrity of exchanges. Casinos with reputations for rigged games eventually drive patrons away. Penalties for insider trading similarly undergird a liquid market in which many buyers bid for stocks offered by anonymous sellers. The fear of trading against better-informed insiders would otherwise lead buyers to demand access to companies’ books. Buyers would also want to identify and understand the motivations of the sellers: Are they unhappy insiders or selling just because they need the money? Therefore, without insider trading rules, stock trades, like used car or real estate transactions, would probably require protracted negotiations between known buyers and sellers.

The SEC’s enforcement of accurate and complete disclosure similarly facilitates trading of the stock of companies that neither buyer nor seller has examined from the inside. For example, the SEC recently filed a complaint accusing the Bank of Boston of failing to disclose fully the deterioration of its loan portfolio. If the allegations prove true, the bank faces SEC sanctions for violating secu-
rities laws as well as possible shareholder suits. Whatever the merits of the case, such actions reassure traders that they can buy a company's stock without an independent audit of its books.

The laws that protect mutual fund investors and pension plan beneficiaries by enjoining broad diversification of portfolios also contribute subtly to market liquidity. The more investors diversify, the more fragmented the stockholding of any company. And fragmented stockholding promotes liquidity by increasing the odds of a trade just because someone needs the money or believes that a certain stock is mispriced.

The historical evidence suggests that, without regulation, stock markets would be marginal institutions. Financial markets in Europe and in the United States developed around debt issues, not equity. "Prior to 1920," Jonathan Baskin notes in the Summer 1988 Business History Review, "there were no large-scale markets in common stock.... shares were viewed as akin to interests in partnerships and were simply conveniences for trading among business associates rather than instruments for public issues." Promoters of canals and railroads - the few businesses organized as joint stock companies - restricted ownership to known investors whom they believed to be "both wealthy and committed to the enterprise." The public at large that time perceived equities as "unduly speculative," and "tales of the South Sea fiasco evoked instant horror."

Public markets for debt issues, however, can be traced back to the 1600s. The first instrument to be actively traded in Britain was the national debt; there and in the United States, most publicly traded securities consisted of government issues until 1870. Later, railroad debt became popular, and, at the turn of the century, preferred issues financed the great merger wave. It is noteworthy, too, that unlike the public equity markets, which would evaporate for long periods following speculative bubbles, the debt markets bounced back from serious crises.

The impact of U.S. regulators can also be seen by looking at the illiquidity of European markets, in which restraints on insider trading, disclosure requirements, and manipulative practices have traditionally been weak. In the Belgian market during the 1980s, which one expert described as "a sad, largely deserted place," insider trading was considered unethical but not illegal. Most European countries had no statutes against insider trading until the mid-1980s, when the European Community directed member countries to adopt a minimum level of shareholder protection laws. U.S. occupation forces instituted laws against insider trading in Japan after World War II, but officials there have largely ignored them.

According to a 1991 survey of 35 markets by Ennis, Knupp & Associates, a pension fund consulting firm in Chicago, markets outside the United States don't require disclosure of the stock owned by principal shareholders, directors, and officers. Financial reporting is also less frequent in most non-U.S. markets, and the reporting lag is typically longer. Companies in most European countries have "broad latitude in creating and allocating funds into and out of reserves," a practice that makes it difficult to interpret reported earnings. Companies generally don't provide fully consolidated statements or individual line-of-business information, both of which are required in the United States.

The Catch

What's wrong with this picture? Shouldn't the managers and stockholders of U.S. companies love the rules under which they operate? In theory, market liquidity makes it easy for investors to diversify their risks and thus reduces the costs of capital for companies. But there's a catch: U.S. rules that protect investors don't just sustain market liquidity, they also drive a wedge between shareholders and managers. Instead of yielding long-term shareholders who concentrate their holdings in a few companies, where they provide informed oversight and counsel, the laws promote diffused, arm's-length stockholding.

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between unscrupulous fiduciaries and company managers, the regulators have effectively barred all but the most distant relationships.

The seemingly irreproachable insider-trading rules place special restrictions on investors who hold more than 10% of a company's stock, serve on its board, or receive any confidential information about its strategies or performance. They must report their transactions, forfeit short-term gains, and avoid any hint of trading on inside information. But why should investors become insiders and be subject to these restrictions just so that everyone else can enjoy a level trading field?

They don't. Institutional investors with fiduciary responsibilities usually refuse to receive any private information from managers. They may grumble about a company's performance, but they will not sit on its board for fear of compromising the liquidity of their holdings. Institutions also make sure they stay below the 10% ownership limit that puts them under the purview of insider-trading restrictions. Thus the rules make large investors resolute outsiders. In a free-for-all market, the same institutions would likely demand access to confidential information before they even considered investing.

Disclosure requirements also encourage arm's-length stockholding. For example, rules that mandate the disclosure of transactions with insiders make a company's banks, suppliers, and customers less willing to hold large blocks of stock or to serve on boards. Disclosure rules also make anonymous shareholding safe. If companies' reports were sketchy or unreliable, shareholders would demand an inside role as well as ongoing access to confidential information.

Market liquidity itself weakens incentives to play an inside role. All companies with more than one shareholder face what economists call a free-rider problem. The oversight and counsel of any one shareholder benefits all others, with the result that all may shirk their responsibilities. This issue is particularly relevant when a company faces a crisis. In illiquid markets, the shareholders cannot run away easily and are forced to pull together to solve any problem that arises. But a liquid market allows investors to sell out quickly—at under a nickel a share in commissions! In economist Albert Hirschman's terms, investors prefer a cheap "exit" to an expensive "voice."

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Diversification rules that cause institutions to fragment their portfolios and the stockholding of the companies in which they invest compound the free-rider problem. The chance that a 20% stockholder will expend resources for the benefit of the group is much greater than a 0.1% stockholder doing so.

Thanks to these extensive rules, transient outsiders now hold a significant share of U.S. stocks. The typical institutional investor's portfolio in the United States contains hundreds of stocks, each of which is held for about a year. Institutions tend to follow the so-called Wall Street rule: sell the stock if you're unhappy with the management. Former SEC commissioner Joseph Grundfest observed in a special issue of the Journal of Financial Economics in 1990. "In both Germany and Japan, corporate investors and intermediaries are able to reach deep into the inner workings of portfolio companies to effect fundamental management change....In the United States, in contrast, when large institutional investors suggest that they might like to have some influence on management succession at General Motors—a company that has hardly distinguished itself for skillful management—they are met with icy rejection and explicit warnings that presumptuous investors had better learn their place."

Outside the United States, the situation is different. There we see large investors whose holdings are immobilized by special classes of restricted stock, long-term financing, or other business relationships. Economists Kenneth French and James Poterba estimated in 1989 that in Japan, 48% of outstanding share value was held on a near-perma-
nent basis by a network of affiliated banks, insurance companies, suppliers, and customers. In all but two countries outside the United States, large, long-term block holdings account for more than 20% of market capitalization.

Richard Breeden, former chairman of the SEC, claims in the January-February 1993 issue of HBR that German and Japanese governance models are "not appropriate to U.S. traditions." In his view, the "closed nature" of the foreign systems "contradicts U.S. values of openness and accountability." However, the historical evidence suggests that investor protection rules, not deep-rooted traditions or values, have fostered the unusually fragmented and arm's-length stockholding that we find in the United States today.

Before the New Deal, investors who took an active inside role in governance played a major role in financing U.S. industry. DuPont family money helped William Durant - and later Alfred Sloan - build General Motors. Investors represented by J.P. Morgan helped Theodore Vail build AT&T and Charles Coffin create the modern General Electric. The investors were in it for the long haul: the DuPonts fought Justice Department efforts to make them sell their GM stock, and they played an important oversight role. Pierre DuPont watched over the family investment in GM as chairman of its board; he reviewed "in a regular and formal fashion" the performance of all its senior executives and helped decide on their salaries and bonuses. According to Alfred Chandler and Stephen Salsbury, DuPont left the details of financial and operating policy to the company's executives but "took part in the finance committee's critical decisions on important capital investments."

Even today, investors in private companies act more like big German and Japanese stockholders than like U.S. institutional investors. Michael Gorman and William Sahlman's research shows that partners in venture capital firms typically manage nine investments and serve on the boards of about half of them. They visit the companies every few weeks, help recruit and compensate key employees, work with suppliers and customers, and help develop strategy and tactics.

The investment strategy of Berkshire Hathaway's Warren Buffett also suggests that Pierre DuPont's careful overseer approach conflicts more with U.S. regulations than with the traditions or values that Breeden invokes. Buffett isn't subject to the same regulatory pressures to diversify as the typical pension fund manager; he, his wife, and his long-term partner and vice-chairman, Charles Munger, own well over half of Berkshire's stock. Berkshire seeks to "own large blocks of a few securities that we have thought hard about," Buffett explains. At the end of 1992, 99.2% of Berkshire's $11.1 billion common stock portfolio was invested in only nine companies. Buffett serves on their boards and will, in a crisis, intervene to protect his investments. For example, in the government-bond-auction scandal at Salomon Brothers in 1991, he stepped in as chairman to make sweeping changes in management. Apparently, Buffett's large holdings of Berkshire stock (and the tax consequences of realizing gains) make him more willing than other institutional investors to accept the liquidity-reducing rules that insiders face. Buffett's favorite holding period is "forever....Regardless of price, we have no interest at all in selling any good businesses that Berkshire Hathaway owns, and we are very reluctant to sell subpar businesses...gim rummy managerial behavior [discard your least promising business at each turn] is not our style," he says.

The Effect on Governance

The degree of closeness of manager-shareholder relationships has a significant influence on the governance of companies. The basic nature of executive work calls for an intimate relationship; diffused, arm's-length shareholders cannot provide good oversight or counsel and often evoke mistrust and hostility.

Managers aren't like agents who execute specific tasks under the direction of their principals; like doctors or lawyers, they have a broad responsibility - a fiduciary one - to act in the best interests of stockholders. As with other fiduciaries, their performance cannot be assessed according to a mechanical formula. Shareholders must weigh the outcomes that they observe against their guesses about what would have happened if managers had followed other strategies. Losses do not necessarily
establish managerial incompetence; the alternatives might have been worse. If concrete performance objectives are set, shareholders must judge whether managers are playing games with the targets—for example, if they are meeting cash flow goals by skimping on maintenance.

To make truly fair evaluations, therefore, shareholders must maintain a candid, ongoing dialogue with managers. But such a dialogue between managers and arm's-length shareholders is impossible. Practically, diffused shareholders cannot have much contact with senior executives: in the typical public company, most shareholders catch only an occasional glimpse of the CEO in a carefully staged road show or a presentation to analysts. Neither can managers share sensitive data with shareholders at large; Indeed, managers must conceal strategic information from them. When a company like Apple struggles to convince potential buyers that its handheld computer is here to stay, for example, its managers cannot reveal to stockholders how disappointing the early sales have been. Moreover, managers who disclose more than what the rules require of them risk shareholder suits: 17% of CEOs surveyed earlier this year by the American Stock Exchange reported that their companies had been sued in the past five years over voluntary disclosures they had made in analysts' meetings, press releases, or speeches.¹⁶

Managers are forced to be circumspect; they can't debate critical strategic issues in public, and insider trading rules discourage private discussions. Almost inevitably, their dialogues with the investment community revolve around quarterly earnings-per-share estimates, even though both sides know well that those figures have little long-run significance.

How wholeheartedly managers will advance the interests of anonymous shareholders is also questionable. Basic honesty and concern for their own reputations as well as fear of public ridicule inhibit flagrant disloyalty and fraud, but the abuses that shareholders must worry about are often more subtle. In Barbarians at the Gate, for example, authors Bryan Burrough and John Helyar report how Ross Johnson, former chairman of RJR Nabisco, acquired a luxurious fleet of corporate jets and ordered flights just for his dog. But having CEOs wait in airports for standby seats doesn't serve shareholders well either. How and where should managers draw the line?

Social norms provide little guidance. In Japan, the chairman of the national airline is expected to resign when a pilot's error causes a plane crash. But in the United States, there is no standard for how Exxon's chairman should atone for the multibillion-dollar Valdez disaster. Rather, the identity and values of the particular individuals whose approval managers seek have a much greater influence on their behavior. For example, CEOs who want to impress other CEOs, and who have no contact with their shareholders, will find it easier to convince themselves that a corporate jet makes them more productive. Executives who know their stockholders and value their esteem, however, will probably be more careful stewards. Similarly, shareholders are more apt to ascribe poor performance to managerial incompetence than to bad luck if their perceptions have been shaped by colorful reports in the press than by personal relationships with a company's managers.

Unfortunately, thanks to the rules, managers and shareholders in the United States now regard each other with suspicion. CEOs complain that investors are fixated on quarterly earnings and are ignorant of companies' markets, competitive positions, and strategies, and therefore cannot evaluate managers. Investors see many CEOs as entrenched, overpaid, and self-serving. As Peter Lynch, the former manager of Fidelity's Magellan Fund, half-jokingly remarked, "I only buy businesses a fool could run, because sooner or later one will." Conversely, CEOs could well ask how the manager of the multibillion-dollar fund even remembered the names of the 1,000 or so securities in which he invested.

The alienation of stockholders and managers makes public equity markets an unreliable source of capital. Accepted beliefs notwithstanding, the exceptional liquidity of U.S. markets apparently does not give publicly traded companies advantages in issuing equity. Jonathan Baskin finds that large public corporations from all the major industrialized nations, including the United States, apparently issue common stock to raise funds "only in the most exigent circumstances" and that macro-
economic evidence suggests that "the quantity of funds raised by new equity issues—especially by established companies—appears to be relatively insignificant."

When public companies do issue equity, Paul Healy and Krishna Palepu report in the Fall 1989 Continental Bank Journal of Applied Corporate Finance, it is rarely to fund attractive new projects. Instead, they issue equity to reduce their leverage in anticipation of increased business risk and therefore increased probability of bankruptcy. Investors in turn regard stock issues with great suspicion. "Investors recognize that managers have superior information and interpret [equity] offer announcements accordingly," Healy and Palepu write. Their study shows an average 3.1% risk-adjusted drop in stock price in the two days surrounding an equity offer announcement.

The stock market does, on occasion, allow companies in fashionable industries to issue stock at lofty prices. But such instances usually represent episodes of "market mania," or what underwriters call "windows of opportunity." When the window closes, investors dump the stocks wholesale and don't give the category another chance for a long time. For example, when the market for biotechnology issues was hot, any company whose name included some part of the words biology, technology, or genetics could issue stock without any products, revenues, or profits. But later, when valuations dropped back down to earth, good biotech companies couldn't raise capital in the public markets to fund their R&D.

Arm's-length stockholding subjects managers to confusing signals from the stock market. Wall Street isn't shortsighted—in fact, the market often values favored companies at hard-to-believe multiples of their future earnings. But companies fall in and out of favor unpredictably: the market abruptly switches from a rosy, long-term view of biotechnology to a fascination with multimedia companies. Understandably so—without inside knowledge of companies' strategy and performance, investors follow the crowd.

Managers, in turn, pursue strategies to protect their companies against apathetic or fickle investors. Uncertain about access to capital when the company might need it, managers avoid paying out earnings to stockholders even when it does not. They reinvest profits, sometimes in marginal projects, and outside shareholders can do little about the situation.

In the 1960s, for example, managers of cash-rich companies in mature industries made acquisitions in businesses that were unrelated to their core capa-
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industry with excess capacity.” Michael Jensen writes in the July 1993 Journal of Finance, managers “leave the exit to others while they continue to invest” so they will have “a chair when the music stops.” General Motors, Jensen calculates, spent nearly $70 billion on its R&D and investment program between 1980 and 1990, only to end up with a company of $26.2 billion in equity value. GM’s investments, he observes, would have been more than enough to pay for the equity value of Toyota and Honda, which in 1985 totaled $21.5 billion. Thus the workings of a stock market that supposedly facilitates capital flows actually help immobilize capital within companies.

Indifference and hostility are also reflected in operating inefficiencies. The worst affront to RJR Nabisco’s stockholders wasn’t the perks for the CEO’s dog; it was the instructions to the head of the Nabisco division not to generate too much profit in any one year so that the company could report smoothly growing earnings.

Apparently, many managers don’t try very hard for anonymous shareholders. Several studies have documented dramatic improvements in profit margins, cash flows, sales per employee, working capital, and inventories and receivables after leveraged buyout transactions that replaced diffuse public stockholders with a few private investors. Steven Kaplan’s landmark study of LBOs in the 1989 Journal of Financial Economics shows that average operating earnings increase by 42% and cash flows by 96% in the three years after public companies are taken private.

The Limitations of External Discipline

What about the so-called market for managerial control? How can CEOs who provide poor stewardship survive the unsolicited tender offer? (Alfred Rappaport calls that “the most effective check on management autonomy ever devised” in the January-February 1990 issue of HBR.)

Actually, unsolicited tender offers constitute a tiny fraction of takeover activity. Most mergers are friendly affairs, negotiated by executives of established companies who are seeking well-managed, profitable targets and will pay premium prices for them. The managerial club frowns on hostile offers.

Raiders serve as a check only against flagrant incompetence or abuse. Profit-motivated raiders like Ronald Perelman or James Goldsmith operate under significant constraints: they must raise money, deal by deal, making their case from publicly available data. Even at their peak in the mid-1980s, raiders posed a threat to only a small number of targets: diversified companies whose breakup values could be determined from public data to be significantly higher than their market values. Raiders could not—and did not—go after turnaround candidates any more than friendly acquirers did.

Outside shareholders, analysts, or takeover specialists cannot easily distinguish between a CEO’s luck and ability. Again, Warren Buffett, because he is a director and major investor in Salomon Brothers, could much more easily assess the culpability of Salomon’s CEO and the consequences of replacing him in 1991 than outside shareholders could. Judgments by managers and therefore of managers are necessarily subjective and require considerable confidential and contextual information.

The case of IBM dramatizes the inadequacies of external scrutiny. Between the summers of 1987 and 1993, IBM’s stock lost more than 60% of its value, while the overall market rose by about the same percentage. The magnitude of the shareholders’ losses was comparable to the gross domestic product of several countries. But while IBM’s stock price dropped relentlessly, the company’s management did not face the least threat of a hostile takeover or proxy fight. Outsiders had no way of knowing
whether or not managers were struggling as competently as they could with problems beyond their control. National business magazines actually carried glowing cover stories in 1991 and 1992 about how CEO John Akers was taking on the IBM bureaucracy and breaking up the company into 13 decentralized units. One year later, journalists found little good to say about his entire tenure.

Wall Street has responded to reduced internal oversight by stockholders by providing better analysts' reports and somewhat greater support for hostile takeovers. But Wall Street's external scrutiny and discipline lack force and have actually increased the alienation between managers and their stockholders. Company executives lobby for antitakeover laws and "poison pills" to fend off raiders; shareholders band together to fight what they view as managers' attempts to entrench themselves.

The Moral Consequences

Arm's-length relationships force managers, who have a fiduciary duty to their shareholders, into a difficult moral position. Fiduciaries have a broad obligation to put their clients' interests ahead of their own: clients come first, before the fiduciary's pecuniary self-interest and before his or her personal values. The primacy of clients' interests may thus require fiduciaries to perform acts they personally consider repugnant, unless they obtain their clients' consent to pursue another course.

Managers may obey the laws and ignore their consciences, but that yields a soulless existence.

The example of an entrepreneur who runs a company that machines and drills flanges provides a concrete illustration. His business was threatened by what he considered an unfair antidumping tariff that would wipe out his suppliers of raw forgings, so he sought to have the tariff removed. In the course of his efforts, however, he found a loophole that eliminated his business problem. Now, taking on federal trade regulators did not serve the best interests of the investors in his business; but, as a good citizen, he felt impelled to continue his efforts to change the regulations.

Fortunately, the entrepreneur could reconcile his fiduciary responsibilities and the tug of his conscience. He could approach the small group of investors, who had backed him on several previous ventures, and get their permission to do whatever he thought was right. Managers of companies with hundreds of anonymous shareholders can't do that.

Managers may therefore always seek to maximize shareholder wealth and obey all laws but ignore the dictates of their own consciences. But that option can force executives into a soulless existence and yield a barren, amoral organizational climate for their subordinates.

Alternatively, managers may unilaterally choose to put their personal values ahead of their shareholders' interests. For example, former Zenith chairman John Nevin waged a campaign against the alleged dumping of TVs by Japanese exporters, a battle that caused the Chicago press to dub him the "Don Quixote of Dumping." Nevin's efforts, which came to naught, arguably represented a personal crusade rather than a strategy to maximize shareholder returns. Zenith's shareholders might have been better served—even if the national interest wasn't—by an accommodation to the alleged dumping. But putting patriotism or other personal values ahead of financial returns without shareholder consent undermines the basis of free enterprise: the moral obligation of individuals to discharge the fiduciary duty they voluntarily undertake.

Some managers might insist that their moral values always coincide with the long-term interests of their shareholders. But that's tantamount to denying the existence of moral business dilemmas. If wealth always followed virtue, we would have conflicts only between the long term and the short term or between stupidity and wisdom. In fact, nothing in the record suggests that the wicked always get their comeuppance. Many blue chip companies were put together at the turn of the century under circumstances approaching securities fraud, and the fortunes of their promoters have survived several generations. Rationalizing away conflicts between moral values and shareholder wealth is simply one more way of breaching fiduciary duties.

The Case for Reform

Although more managers, investors, and policymakers than ever before recognize the gravity of the problem, ignorance of the connections among investor protection, market liquidity, and governance has led to ineffectual or even counterproductive measures. For example, according to Richard Breeden in the HBR article already cited, the SEC...
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SECURITIES REGULATIONS

has sought to strengthen “broadbase participation in corporate governance” and thus ensure “both a strong and open investment market and prompt and meaningful managerial accountability.” Accordingly, the SEC recently eased restrictions on communications among shareholders and mandated disclosure of the process that companies follow to determine executive compensation. Michael Porter has suggested that companies report strategic as well as financial data to get investors to focus more on long-term prospects than on short-term earnings. But I believe that both steps only encourage arm’s-length shareholding, exacerbate the problem of inadequate internal oversight, and increase conflicts between shareholders and managers.

Good governance requires real policy trade-offs. Clever tinkering with insider-trading and disclosure laws cannot get around the basic conflict between market liquidity—which requires transient, arm’s-length shareholding—and close, honest shareholder-manager relationships.

If they understood the trade-offs better, however, the beneficiaries of the existing system probably would resist changing the rules. The number of shares traded per year now exceeds 60% of all outstanding shares. If trading fell to the 10% to 20% rate of previous decades, the fall in commissions, which in 1993 exceeded $13 billion, would send shock waves through New York’s financial districts. Without SEC safeguards to reassure investors, underwriters could do fewer public stock offerings. Profits from analyzing and packaging information on market prices and corporate performance would decline. Without disclosure requirements, some companies (utilities, for example) might continue their current reporting practices, but many others would not.

If inside stockholders could block ego-driven acquisitions, many mega-fee deals would disappear. If stockholders were able to provide informed oversight, they could limit corporate diversification and growth: very large public corporations would be limited to sectors with compelling economies of scale or scope. Fund managers would be forced to retool: many who now seek discrepancies between a stock’s price and its intrinsic value would, like venture capitalists, have to try to increase companies’ values through counseling and oversight.

An active governance role for institutional investors would also conflict with a risk-averse regulatory ethos. Allowing mutual fund and pension fund managers to concentrate holdings and sit on boards increases the risk of self-dealing and would require clients to exercise more vigilance and prudence. Occasionally, greed, lax scrutiny, or inge-
nious fraud could lead to serious losses. But should good public policy sacrifice the interests of the many to guard against the imprudence or bad luck of the few? Should the possibility of a few pension fund scandals get in the way of better governance for many companies?

Better governance could unlock enormous value by reducing the invisible inefficiencies that external markets can’t detect.

Although more trust creates opportunities for greater fraud, we should recognize that hostile, arm’s-length relationships embedded in a liquid market have led to the widespread dissipation of resources. According to one estimate, the total cost of trading stocks consumes resources equal to about one-sixth of the total earnings of U.S. corporations. The 30% to 50% premium over market prices, which is usually paid when companies are taken private, suggests that better governance arrangements could unlock enormous value by reducing the invisible inefficiencies that external markets can’t detect. For at least two decades, public corporations with diffused ownership have not invested their vast resources wisely. Entrepreneurial, privately held companies have taken over as the engines of innovation and job growth. To justify reform, increased internal oversight has only to block some faddish mergers, shake up a few companies like IBM or GM before their losses become a public embarrassment, or promote a lean-and-mean ethos before a recession forces painful restructurings.

Moreover, the stock liquidity that would be lost is dispensable: investors can and should use bonds and bank deposits for their liquidity needs and treat stocks as long-term holdings. Liquid markets play a valuable economic role—in physical commodities or well-secured, standardized contracts such as government bonds or currency futures. No one would expect to trade claims on the services provided by doctors or lawyers, so why should the services of managers be treated differently?

Managers, too, would benefit from reforming a system that undermines the legitimacy of their role. Informed oversight by inside stockholders might bother insecure executives who would prefer to deal with pliant boards of directors. But I believe most managers would feel liberated. Fiduciaries who must make difficult judgments gain from the support of informed principals. GM’s investments in the 1980s might have proved just as unrewarding with a Pierre DuPont as chairman, but GM’s executives would not have been accused of self-serving or insular behavior. Stockholders should bear the ultimate responsibility for ratifying long-term strategies and for selecting and rewarding managers. Moreover, the current system robs managers of the opportunity to gain the respect and approval of their shareholders. Now they are stuck having a duty of care and fidelity to faceless stockholders whose gratitude they can never experience.

"Trust that the people with whom you deal will not only obey the law but will also fulfill the fiduciary responsibilities inherent in their relationships is as essential to the working of the capitalist system as a sound currency and a reliable legal system," Herbert Stein writes. U.S. regulators have unwittingly weakened that trust. Managers and their stockholders have a common interest in the reforms that would restore it.
